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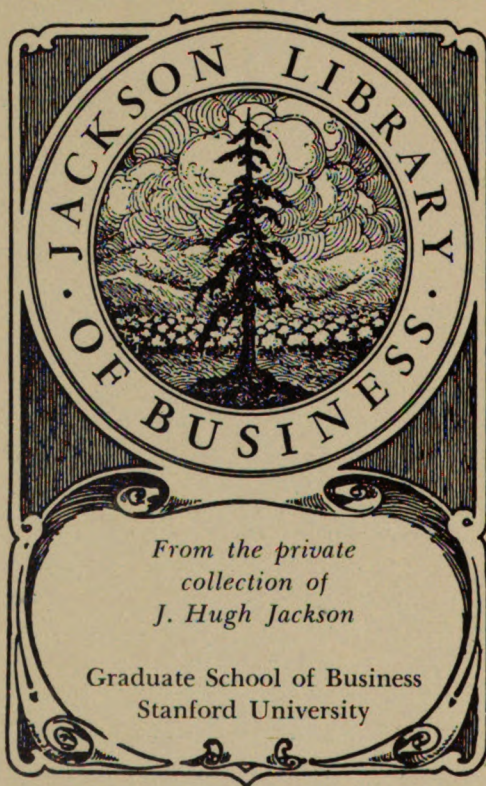
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The Interrelation of Financial and Operating Data

BY WALTER A. STAUB, C.P.A.

Not more than a generation ago, an "audit" frequently, if not usually, consisted of a comparison of vouchers, *i. e.*, receipts for moneys paid, with the record of payments as set forth on the credit side of a cash book and the verification of the cash balance at the end of the period under review. The correctness of the record of receipts as set forth on the debit side of the cash book was more often than not simply taken for granted. The report consisted either of a notation on the cash book at the closing date of the audit period reading, say, "Audited and found correct" and signed by the auditor, or it consisted of a very brief letter or certificate stating, for example, "I have audited the accounts of Blank for the year ended 31st December 18— and found them to be correct."

A survival of this form of audit is still to be found in the "audits" conducted by auditors appointed by the courts in estate cases—the audit in such cases consisting largely of an inquiry as to the items for which the executor, trustee or other fiduciary agent should account and the integrity of the account as regards the expenses claimed to have been paid or other disposition made of the funds of the estate. In such audits comparatively little consideration—in fact, it may be said ordinarily no consideration—is given to the degree of efficiency with which the trust has been administered.

Great advances have been made in the field of public accountancy in the past generation—yes, even in the last five years—and the professional accountant of today must have a broader

vision than his forerunner, and must be prepared to assume responsibilities which would make the practitioner of earlier days shudder. Business methods are different today from what they were before the telephone and typewriter had come into use, and so the public accountant of today can no longer be a mere checker of vouchers as in the early days. He must be able to visualize the operations of a business; that is, he must be able to see them in such a way that he may point out unfavorable tendencies, inefficient or improper management, and in general render constructive service.

To be sure, the accountant's responsibility, or what is expected of him, is not yet alike in all cases. Some business men who avail themselves of the accountant's services do not yet realize their scope or possibilities or are not prepared to accept services other than auditing in the narrower sense of the word. Even though this be true in some cases, however, every progressive accountant feels an ever increasing responsibility and realizes that the demand of the times is for greater efficiency and usefulness of service.

All that has so far been written will be generally admitted, and the question is: How can the accountant increase the value of his services and best measure up to what is already expected of him in many quarters and fit himself to meet the ever expanding requirements?

One way to do so is to take advantage of every opportunity to relate or connect the data appertaining to the physical side of his client's operations with the statements reflecting the financial aspect of the operations. This is by no means a new or novel plan, but it is not used by all accountants as fully as it might be and the value and importance of it are, perhaps, not realized by all accountants as much as they should be.

NEED FOR RELATING FINANCIAL AND OPERATING DATA

A well arranged statement of earnings and expenses serves a useful purpose and conveys more or less valuable information. It is difficult, however, for an interested party to determine from a study of a statement showing merely the amount of money earned, the amount of expenses incurred and the resulting profit or loss, how efficiently the operations of an enterprise have been

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conducted. Furthermore, it is extremely difficult, and in many cases impossible, to compare the relative efficiency of two concerns in the same line of business when only their financial statements are available for comparison. When we leave the realm of strictly business undertakings and consider municipalities and institutions, the comparison merely of their financial statements is usually of little significance.

Now in many industries and in many governmental and institutional functions, a unit of production or service can be found for expressing the volume of production or service, which can be used to show the realization and cost per unit of production or service. In many factories the variety of product is such that it is not possible to fix on any one unit of production which can be made the basis for stating the volume of production or sales of even one department, not to mention the entire factory.

For instance, a machine shop doing a jobbing business or manufacturing only on orders according to the purchasers' designs, could not express its production or work done in terms of any one unit which would indicate the volume of production and consequently permit of ascertaining the cost per unit of output or of sale. The same thing is true of printing shops, furniture factories and many other manufacturing establishments which will readily come to the reader's mind. For such concerns, more or less detailed cost accounts are necessary in order to permit of the management's critically studying the operations. It is surprising, however, how many industries do lend themselves to the treatment indicated, *i. e.*, that the operations can be stated not only as to their financial results but also in a broad way as to the volume of either production or sales in terms of a given unit, from which data the realization and cost per unit can then be determined.

INDUSTRIAL UNITS OF PRODUCTION

Among the industries whose operations are susceptible of such treatment, may be mentioned the following:

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| <i>Industries</i> | <i>Units of Production</i> |
|---------------------------|---|
| Mining: | |
| Coal | Ton coal |
| Iron | " iron |
| Precious metals | Pound metal |
| Quarries | Ton stone |
| Lumber camps or saw mills | Thousand feet logs or lumber |
| Coke ovens | Ton coke |
| Cement mills | Barrel cement |
| Foundries | Pound iron, brass or other castings; or ton of cast iron pipe |
| Rolling mills | Ton or pound of bar iron, shapes or rails |
| Blast furnaces | Ton pig iron |
| Flour mills | Barrel flour |
| Linseed plants | Gallon oil |
| Tanneries | Dozen skins (kid) or square foot hide (calf or kid) |
| Automobile factories | Machine (where only one type is made) |
| Spinning mills | Pound yarn |
| Knitting mills | Dozen garments |
| Textile mills | Yard cloth, ribbon, etc. |
| Creameries | Pound butter |

In some businesses there is but one final unit, as in coke manufacturing, where the unit is the ton of coke produced. In others, for instance knitting, there may be a general unit, such as dozen of stockings or underwear, but different sizes thereof. Consequently care must be exercised, when dealing with a concern of the latter class, in using the total quantity of production, as unit costs are in such cases really averages of a number of varying units and the proportion of large and small sizes in the total output may vary from one fiscal period to another.

Even in such cases, however, it is often found that there is considerable uniformity from one period to another. For instance, underwear is usually sold with a given assortment of small, medium and large sizes in a given quantity. The accountant's experience and judgment must indicate to him just how far it is safe to make use of a general or average unit of production in a business where one absolutely uniform unit does not obtain.

The fact that in some factories which have a standard unit of production, such as yard of cloth or dozen of underwear, there are many different grades or qualities of articles produced

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must also not be overlooked. This may be the case to such an extent that it would not be safe to base any conclusions on totals of units which are uniform as to quantity but not as to quality. On the other hand the volume of production and sales is valuable information, even though the averages which would be obtained by dividing such quantities into the corresponding money amounts might be of little value or even misleading. This is another case for the accountant to bring his good judgment and past experience to bear in deciding how far to go in making use of such data.

The unit of production may vary with the successive processes in a manufacturing operation for which there is one final unit. As an example may be cited the manufacture of cement. Here the final unit is the barrel of cement made and the figures showing the total number of barrels produced and sold respectively, the cost per barrel made and the realization per barrel sold during a given period are in themselves sufficient to give quite an insight into the operations of a cement company, especially if they are considered by one having some familiarity with the market conditions which obtained during the period under review.

Much valuable information is obtained, however, if the volume of each of the operations preceding the ultimate production of cement is ascertained and correlated with the cost chargeable to each operation. This would involve ascertaining the following data:

| <i>Operations</i> | <i>Production Units</i> | <i>Operation Costs</i> |
|-------------------|------------------------------------|--------------------------------|
| Quarrying | Tons cement rock and limestone* | Total quarrying cost |
| Grinding | Tons ground rock | Total rock grinding cost |
| Clinkering | Barrels clinker | Total clinkering cost |
| Grinding clinker | " cement | Total clinker grinding cost |

The quantities of rock (ground and unground) and clinker on hand at beginning and end of the period must be dealt with in carrying forward from each operation in the manufacturing process to the succeeding operation the quantity of rock or clinker used and the cost thereof. This offers no particular difficulty.

* If the company does not have its own limestone quarries, the quantity and cost of purchased limestone is best dealt with separate from the quarrying of cement rock.

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With this data, the cost per unit in each of the several distinct operations can be easily calculated. The costs in each operation can be analyzed still further, but the data already indicated would of itself be sufficient to permit of valuable comparisons of the operations of one period with those of another, or with the operations of other plants in the same industry.

In making such comparisons, however, it is necessary to compare both volume of operations and unit costs. The volume has a large bearing on the unit cost and an increase in unit cost may be entirely due to a falling off in volume of operations. On the other hand, a unit cost which is about the same or falls slightly from one period to another should perhaps show much greater decreases because of greatly increased volume of operations with correspondingly increased opportunity for utilizing the possibilities of effective organization and system and thinner spreading of the "overhead."

One very helpful feature of a statement which combines financial and operating data and unit realizations and costs is that it makes it possible to determine how far an increase or decrease in profits is due to a rise or fall in prices of goods sold and how far to a decreased or increased manufacturing cost. This a purely financial statement cannot show. The sales of product may show a decrease in a given period as compared with the preceding period, yet there may have been an increase in the quantity of sales but a big drop in the prices realized. With both the quantity of sales and the average unit realization ascertained, the bearing of each of the several factors is plainly seen.

In addition to giving a better picture, as it were, of the operations than a financial statement alone can do, a combination of operating and financial data, wherever it is feasible to effect it, also has considerable value from an auditing standpoint.

In this connection it is interesting to consider for a moment the famous Kingston Cotton Mill case * which has so often been mentioned in discussions on inventories and the auditor's responsibility regarding them. In this case the padding of the inventories was continued over a period of years to bolster up decreasing profits. During the entire period in which the falsifi-

* The essential facts in this case will be found in the court's opinion in *MONTGOMERY'S Auditing, Theory and Practice*, pp. 577-579.

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cation was practised, the company's accounts were being regularly audited.

An old saying has it that "hindsight is easier than foresight" and it is not wise to criticise too harshly the practitioners of twenty years ago who had not the light which we enjoy today. Yet it may safely be said that had the auditor in this case not rested content with accepting the manager's certificate to the correctness of the inventory and preparing a profit and loss account on a currency basis only, but had carefully considered the available operating data, or—as it might also be put—had constructed a profit and loss account dealing with the *quantities* of yarn and cotton on hand at beginning and end of each period, and of cotton purchased and yarn sold during the period, and making allowance for the usual loss of weight in manufacturing, the fraud would surely have been discovered. The quantity of cotton and yarn in the inventory would so far have exceeded the quantity called for by the foregoing calculation, that the discrepancy would have invited searching investigation.

Another use of operating data by the auditor, somewhat analogous to that just described, is the use of it as a basis for determining approximately the profits which should have been realized from a given volume of operations. For instance, in the linseed business, there is a more or less definite relation between the market price of flaxseed and the market price of linseed oil which is extracted from flaxseed. If a linseed manufacturer eliminates the speculative element from his business by "covering" sales of oil with purchases of flaxseed options, the profit to be realized may be figured by multiplying the number of bushels of seed which were put through the process by the expected rate of profit per bushel of seed. Of course, it will not work out exactly, and disturbing factors other than fluctuations in the price of seed (the raw material) and of oil and linseed cake (the products) at times may be encountered, but the very fact of reckoning with these factors and determining their effect will be a satisfaction in stating the operations and may result in placing valuable information before the client.

PUBLIC UTILITY UNITS OF SERVICE

The operations of most public service corporations lend them-

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selves very readily to the correlating of their physical and financial aspects in a combined statement. It is in this field, too, that probably the widest use has been made of this method. The most generally used service units, as they may in the case of such operations be called, are as follows:

| <i>Utilities</i> | <i>Units of Service</i> |
|--------------------------|-------------------------------------|
| Railroads | Ton mile (freight) ; passenger mile |
| Electric railways | Car mile ; car hour ; passenger |
| Electric light and power | K. W. hour |
| Gas companies | 1,000 cubic feet gas |
| Water companies | 1,000 gallons water |

The telephone companies form about the only class for which it is difficult to find a satisfactory service unit. If only the city exchange business had to be considered, the problem would be easily solved, as the number of calls made would be a natural and satisfactory basis for stating the volume of operations and for determining the revenue and operating cost per unit of service (the individual call). The long distance service, however, introduces a complicating factor, as the total number of calls in one period, resulting from the combining of local and long distance calls indiscriminately, is very likely to be noncomparable with a like total for another period and particularly for another district. When the revenue and the operating expenses of strictly local business can be completely segregated from those appertaining to long distance business, the calls made can be very satisfactorily used as a basis for stating volume of operations and unit cost of operation and unit revenue.

In the case of some utilities, the operations must be divided into two or more sections and a distinct service unit used for each. In the case of railroads, for instance, the revenue and operating cost of freight and passenger service must be segregated if the units of ton mile and passenger mile are to be employed. As to the revenue this is readily done, but as to the operating expenses this is not so simple, as many of the expenditures are for the common benefit of both classes of service. The maintenance of way and general expenses are pertinent illustrations.

When it is borne in mind, however, that in determining manufacturing costs, a very considerable portion of the factory expenses must be apportioned among the various articles manufactured on a more or less arbitrary basis, there is really no

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reason why in the case of railroads and similar utilities expenses which apply alike to several different classes of service should not be apportioned among the several services in a way that careful observation and study indicate to be as fair as possible. Unless such a separation or apportionment is at least attempted, the cost of performing each different class of service is not even approximately known, and with the ever increasing regulation of rates charged by public utilities this is surely most important.

Of course, the units shown are by no means all that can be employed. Different units may be applied to various groups of operating expenses, as, for instance, the cost of maintenance per mile of track and in turn the number and cost of ties per mile of track and so on.

GOVERNMENTAL AND INSTITUTIONAL UNITS OF SERVICE

It might at first glance be thought that expenditures for various kinds of governmental service or functions would hardly yield themselves to the kind of treatment which has been advocated for the stating of industrial and public service operations. It is true that for some kinds of services it is most difficult to find a satisfactory unit of service; on the other hand it is also true that careful study and analysis show that such units can be found for expressing the quantity of various kinds of service and for stating the cost per unit of service more often than might be thought.

In the case of water works, gas plants and similar utilities, the same service units would naturally be used as by public service corporations. In the case of garbage disposal, for instance, the tons removed would express the amount of service; of street cleaning and street maintenance, the square yards of street area cared for; of police and fire service, the population served or square miles covered, or both; of inspections of various kinds, the number of inspections of each kind made.

For schools the cost per pupil and for hospitals and asylums the cost per patient are good units. Effective use of such unit costs can be made by comparing the cost not only in one city with that in another, but also by comparing say, the cost per pupil at one school in a city with the cost at other schools of the same grade in the same city.

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Some years ago the writer's firm, in reporting on the accounting methods of one of the large cities of the country, recommended that the classification of the city's expenditures by activities, functions or operations

be developed into a complete cost system by extending it to provide also for the complementary records or statistics of the quantity of work performed or service rendered. Thus sufficient data would be available for determining not only the total cost of a certain kind of service such as street cleaning, but also the length and area of streets cleaned and the cost per square yard. * * * The importance of developing the city's accounting system along the lines indicated is especially emphasized when it is remembered that the ultimate test which may be applied to determine whether or not a business enterprise is successful cannot be used to determine the efficiency of the conduct of a municipality's financial affairs. Business administration in the ultimate analysis has in view the earning of profits, and the accounts, if intelligently stated, will show how far this end has been achieved. On the other hand governmental administration is not concerned, directly at least, with earning profits but with rendering services to the community which presumably are to be paid for at cost by the community by means of taxes or special assessments. Hence it is that comparatively slight changes for the better or worse in the results of the administration of *business* enterprises are automatically brought to the attention of an ordinarily observant management by the fluctuation in net profits for succeeding periods of operation, while the cost of exercising governmental functions or performing public services may gradually increase in greater proportion than the growth of population or other causes warrant without the fact being noticeable excepting to the unusually vigilant. Even if expenditures do not increase, the service rendered may not represent full value for the expenditure made and yet the fact not be so obtrusive as to attract the attention of the average taxpayer.

Actual or potential competition tends to compel the manufacturer or merchant to give adequate value for the money received from his customers. This spur to efficient service is almost entirely wanting in governmental administration. There is no competitor offering to furnish a better article or more efficient service for the same expenditure. It is only in the case of municipalities operating such enterprises as lighting or water supply plants that a private corporation sometimes assumes the role of the competitor by offering to operate the plant more efficiently, and to the greater financial benefit of the city or the consumers or both, than the city appears to be able to do.

There is another very important distinction between business enterprises and municipalities which has a decided bearing on the expenditures of moneys in connection with their administration. In the case of business undertakings their revenue is limited to the return from their expenditures, and extravagant or unnecessary expenditures are not offset by a corresponding return of income. There is thus an inherent necessity for keeping expenditures within the bounds of the income which they may reasonably be expected to produce. On the other hand, municipal expenditures are not, in the main, expected to produce direct revenue and the rate of taxation may be indefinitely increased to provide the funds for making extravagant or unwise expenditures.

It is obvious that detailed information, not only as to the cost but the quantity of service rendered, must be had before the taxpayer, or those representing him, are in a position to commend or criticise intelligently the administration of the city's activities.

Soon after the report, from which the foregoing extract is

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quoted, was made public by the commission for which it was prepared, DR. WILLIAM F. WILLOUGHBY, assistant director of the census, read a paper on *The Correlation of Financial and Physical Statistics of Cities* before an annual meeting of the National Municipal League. The bureau of the census in its published statistics of cities has for some years been comparing the unit cost for certain kinds of municipal service in various cities.

In the city before referred to, a complete cost system has since been installed for the board of education. The expenses, classified as to tuition, supplies, building maintenance, etc., are kept separate for each of the schools in the city, there being considerably over a hundred schools in all, and costs per pupil are worked out for the various classes of expenses. The comparison of the costs at the various schools and of the expenses for maintenance of buildings and of equipment at the different schools yields information of great administrative value.

In conclusion, it may not be amiss to quote from another public report on unit costs as related to municipal service which also applies to some extent to the consideration and comparison of unit costs shown for the operations of industries and public utilities.

Unit costs are of great value for administrative and other purposes, but they are only one of several factors which have to be taken into consideration in determining whether or not a city's activities are being efficiently conducted. A low unit cost is not in itself conclusive evidence that real economy is being exercised in conducting the affairs of a city or institution. For instance, the cost per capita of operating the city homes and hospitals might be very low as compared with similar institutions elsewhere and at first glance it would seem that they were being operated on a remarkably economical and efficient basis. As a matter of fact, however, the low cost might be secured by supplying insufficient food—or of an inferior quality—to the inmates, or by having too small a staff of doctors and attendants, or again perhaps by “skinning” the maintenance of the buildings and other equipment, i. e., by failing to spend the amount required to maintain the equipment in the best of condition and in keeping with the most modern standards. This being so, it is desirable that unit costs shall be obtained not only for the operation as a whole, but for the component parts thereof. *E. g.*, the cost of conducting homes and hospitals should be shown not only in total per capita, but also the per capita for such leading items as salaries of attendants, subsistence, clothing, house furnishings, repairs, etc.

Furthermore, in conjunction with the ascertaining of unit costs as a basis for intelligent criticism of the conduct of the city's affairs, it will always be necessary to make observations at close range of the manner in which work such as that at the city institutions is being carried on, whether it is in accordance with the best practice or whether methods are antiquated and behind the times. Methods of caring for the unfortunate,

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particularly the insane, have undergone radical changes in recent years, and the design of the buildings and the auxiliary equipment required for the housing and treatment of the patients have likewise been vastly improved.

We would not have it inferred from the foregoing paragraphs that unit costs and comparisons between different localities have little or no practical value. Of necessity the conditions obtaining in each case must be learned, but the conduct of municipal activities tends toward an average percentage of efficiency the country over, and a notable divergence from the average cost indicates a necessity for ascertaining whether a high cost is due to a high standard of service performed or whether it is due simply to extravagant or inefficient management; and, on the other hand, whether an unusually low cost be due to higher efficiency than the average or to a lower standard, *i. e.*, poorer quality of service. As a general rule, it may be said that the comparison of the cost of conducting the activities of one city with costs of like activities elsewhere will indicate to a very considerable extent, even if not conclusively, the degree of efficiency of management in the city under consideration. Certainly if it costs less to perform the same service elsewhere it behooves a city to ascertain whether the quality of the service being performed elsewhere is equal to its own, and, if so, whether it is not feasible to reduce the cost of its own service. On the other hand an abnormally low cost compared with that in other localities may well raise the question whether the community is performing the full measure of its obligations to its own citizens.

Cost Accounting Practice, With Special Reference to Machine Hour Rate*

BY CLINTON H. SCOVELL, M.A., C.P.A.

There is more reason now than at any other time for many years why American manufacturers should consider most carefully the problems of finance and management of their business undertakings. Facing the prospect of increased foreign competition in some lines, and the tendency towards higher wages which inevitably follows the increased cost of living, and especially the increased cost of food, which makes up such an important part of working men's expenses, manufacturers are necessarily interested in any ways or means to make their industrial operations more efficient.

Many things contribute to the efficiency of shop management. When a business is small, its success usually depends on the ability, foresight and good judgment of one or two energetic men. As the business grows, methods and system must more and more take the place of the manager's personal oversight, and the need increases for accounting sound in principle and simple in operation.

Under the influence of the new science of management, there has been a constant study in the last few years of manufacturing methods, operating standards, cutting speeds, etc., resulting many times in such marked increases of production that the management may be sure that an improvement has been made, even if it does not know exactly *how much* saving has been effected.

It has been clearly established, however, that the cheapening of manufacturing operations which is brought about by a better operating practice is frequently secured at a considerably increased cost for office force, planning departments, helpers, supervision and other indirect labor, sometimes wrongly called non-productive. As a result the practical problem for the manufacturer is to compare the lessened direct cost for labor and equipment with the increased cost for the other factors. This

* An address delivered before the annual convention of the National Association of Machine Tool Builders, Hotel Astor, New York, October 22, 1913.

he can do only when he has an adequate cost accounting practice.

It is my purpose to point out the essentials of a cost system for a machine shop, or a manufacturing plant where the operating conditions are similar, with especial reference to the theory and practice of a machine hour rate. I expect to show you that this is an intensely practical matter, and that it has an important bearing on the sales policy and the general management of your business.

Classify Expense Properly—Distribute it Correctly

Good cost accounting depends on the correct application of a few well understood principles. The first is to have the direct charges from the original sources, that is, pay-roll and material distributions, correctly classified between direct and indirect costs, and then to determine how the indirect, or so-called non-productive charges, may be identified with the product.

Any cost accounting practice worthy of the name should record accurately the direct labor costs. In a machine shop, or under similar conditions, this direct labor cost should be applied with precision to each job going through the shop. Very little cost accounting practice, however, has attained any similar precision for distributing the indirect charges for equipment, referred to hereafter in this article as *burden*.

What is Burden?

As the difficult and important part of cost accounting is to determine how a correct distribution of burden may be accomplished, it is clearly worth while to consider briefly the elements of burden.

It is a tedious and expensive undertaking to build and equip a new plant, and to complete the cycle of manufacture from design to finished product; and there is much to gain in the way of a clear understanding of costs, if we trace out this development step by step, taking careful note of the elements of the problems as we proceed.

When a new industry is to be established, the directors first buy a parcel of land suitable for the location of the proposed shop. If the purchase price is \$40,000 the new enterprise has at once absorbed capital that should earn about \$2,000 to the

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ordinary, prudent investor, who takes no manufacturing or trading risks. A site as costly as this is probably situated in or near a city, so that it will be subject to taxes of \$500 or \$600.

Shop buildings are next erected at a cost, let us say of \$200,000 more. This outlay of capital, like the investment in land, involves an annual interest charge (of some \$10,000), and under present laws, an annual penalty of some thousands of dollars more for taxes. But, unlike land, the buildings will require constant repairs. Even then they are subject to a slow but certain deterioration and obsolescence that must be met by a charge for depreciation. To protect the investment, the owners must pay insurance and provide watchmen. To make the buildings usable, they must be heated and lighted, supplied with water and fresh air, and regularly cleaned. The striking thing about these charges is that they all go on without any abatement, unless the shop is shut down, dark and cold, and even then the principal charges—interest, taxes, insurance, repairs and depreciation—abate scarcely at all.

All this expense has been incurred by the management to provide suitable areas for the intended manufacturing process. If there are five or six subdivisions, each one may occupy an entire small building, or all or part of a floor in a larger building. Whatever the details, each department (if we may use that overworked word) uses so many hundred square feet of floor space and must carry its proportionate share of the land and building charges already described.

Within a department there may be one or more different operations, such as, milling, grinding, boring, turning, planing, fitting and assembling. The equipment in each case represents an investment of capital; it requires the payment of taxes and insurance; it suffers depreciation (even more rapid than the building), and it incurs charges for power, repairs, and such indirect items as superintendence, inspection, and helpers' services. If the shop shuts down, the power may be shut off and the foreman dismissed; but so long as it runs, however short handed, or however inefficient, these charges do not change materially; and the fundamentals of interest, taxes, insurance, etc., (with the possible exception of repairs) are not one whit less.

All that has been described so far is overhead expense, more

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properly termed *burden*, and does not include any labor applied directly to the product (like the operative who is working at a lathe or boring mill).

This great accumulation of burden *represents manufacturing capacity*. Each department, and each separate machine tool has a known annual burden. Its cost per hour is determined by dividing the total burden by the hours in the working schedule, and the shorter the schedule, the greater the hourly cost.

Having completed the buildings and installed the equipment, the management is ready to begin manufacturing operations. As the several parts of the machine progress from rough castings or forgings to finished pieces ready for the assembling floor, their value has increased as they have absorbed the successive increments of direct or productive labor and of the burden appertaining to the production centres through which they have passed.

Cost Accounting and Production Control

Before illustrating the practical application of this theory, I want to point out that good cost accounting is a help to efficient management, not only as it traces and records values but also as it may be made a powerful agent for production control. From my experience in professional service for industrial plants, I emphasize more and more the practical value of this second aspect of the work.

It follows therefore, that the first step in planning a cost accounting practice for a machine shop is to consider by whom and how authority to manufacture shall be made. It is simple enough to order ten castings from a given pattern which has already been made, but as you all know, the production of a machine tool involves orders for castings of many different patterns and sizes, bar stock for forgings, etc., and these material orders are all very simple in comparison with the complex schedule of machine operations which are required to produce the finished parts. You all recognize how important it is that parts should be made in quantities that are economical and that the different pieces required should all be ready together on the assembly floor. It is, therefore, of the utmost importance to make effective plans to initiate and control the production so that these results may be accomplished. The management will

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then have a definite schedule of manufacturing operation on which costs may be determined by orders, by lots, by individual parts—with as much or as little detail as may be necessary.

What Constitutes an Adequate Cost Practice

Returning now to the subject of specific costs, the first step is to provide such labor records, preferably with good automatic time stamps, as will make possible the necessary distinction between direct and indirect operations, and the exact time devoted to each lot of material or each expense order.

The next step is to compute the burden correctly for each department, including interest, taxes, insurance and depreciation on the buildings and equipment, and the additional charges for power, supervision and repairs. In many industrial plants "manufacturing expense" includes only part of these charges. The first cost of manufacturing is plant investment—land and buildings. No management using a rented plant would think of omitting rent from overhead charges. When the manufacturer becomes also a landlord, as when the plant is owned by the manufacturing company, what sound reason can possibly be given for omitting from burden the charges which the management incurs in lieu of rent?

The equipment presents a slightly different problem. Very few manufacturers operate with rented equipment; if they do, there is rent to pay, as an unavoidable burden on the manufacturing operations. When the equipment is owned, the maintenance charges are equally unavoidable. The manufacturer must get interest on his investment before he has in any sense a profit, and he must bear the expense of taxes, insurance, depreciation and repairs. Although these elements of cost may be neglected or not stated, they are, nevertheless, taking their proper share, or more, of what is figured without them as gross profits.

The weakness of many cost systems is that important elements of indirect cost are thrown together in a "general expense" account, concealing the leaks and wastes that reduce efficiency and curtail profits. Many manufacturers have no doubt been satisfied to handle burden in vague and general terms because they did not know any better way to dispose of it.

It may be stated confidently that under ordinary machine shop conditions, no accurate distribution of burden can be ac-

complished, and therefore no accurate costs determined, by spreading burden over all the work done in the shop as a percentage of the cost of direct labor. In the shop proper, with its widely varying equipment of machine tools, distribution on the basis of a man hour rate is not very much better, although, as I shall point out later, that plan works very well for fitters and assembly men.

To secure a correct burden distribution it is only necessary to prove, by analysis, the elements of which it is composed and then to consider how all this overhead is actually applied to the product.

Attention Should be Fixed on the Production Center

At this point we encounter another mistaken tradition of "departmentalized costs." To define burden correctly in each department is good as far as it goes, but it does not go very far, especially in a machine shop. The attention of the manager and the cost accountant ought to be fixed on the individual production centre, usually a power machine. Recent developments under actual shop conditions show that the correct burden for a machine tool may vary from less than ten per cent to over three hundred per cent of a machinist's wages. The widely accepted method of charging burden to costs on the value of productive labor makes no distinction between the mechanic at the bench, whose work has practically no burden except supervision, and the operator using a costly machine, which involves heavy charges for maintenance, power and repairs.

Fallacy of Average Rates

Face this situation squarely and the fallacy of an average rate is exploded forever. Instead we recognize as many elements of burden as possible, and while it is not necessary or desirable to apply these elements separately to the cost of each job, it is from every point of a view desirable to identify the burden with the production centers through which it is charged to the jobs. For machine tools, under this plan, there is a charge to each job for the use of a tool as specific and as definite as the charge for the wages of the mechanic who operates the tool.

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Bench Hands and Assembling Crews

The work of bench hands and mechanics on the erecting floor must be accompanied by a burden charge which obviously is not literally a machine hour rate. The burden rate for bench equipment differs not at all in principle from the rates for the machine tools. If, as is usually the case, the mechanics at the bench work under substantially uniform conditions, a uniform rate may be made at so much per hour for the use of the accommodations which they require for their work. In a large shop the bench rate might be different in different departments. Since it is uniform for all mechanics who work at the bench, it is practically a man hour rate. It must be borne in mind, however, *that it is a rate for the use of equipment only*, unless indeed the circumstances make it convenient to merge the cost of supervision with the cost of equipment.

The erecting hands in a shop present a problem of a different kind. Their work usually requires a considerable area, and important charges for crane service and supervision. To speak of this work in terms which have long been familiar in cost accounting practice, the erecting floor may be considered as a department whose burden is to be distributed with reference to the work performed by the mechanics employed in the department. Probably the best way to distribute this burden is on a man hour rate derived by dividing the total annual burden by the number of man hours for the department.

General Burden

There are other charges connected with the management of a machine shop or manufacturing plant which are not necessarily well expressed through an hourly equipment rate. Such are charges for the drafting room, the bookkeeping, cost accounting, supervision, liability insurance, and general charges of management not specifically and directly connected with the maintenance and operation of machinery. These are charges which in a small shop should be applied in a fairly uniform way over all the employees in the establishment, preferably on a man hour basis. This charge would be known as general burden, and since it would be uniform, it may be applied to the cost of each job, against which hours of mechanics' time have already been recorded, with very little additional work.

Why Scientific Machine Rates are Important

The successful operation of a scientific machine rate is the most important development that has occurred in cost accounting practice in a generation. As these rates may be applied to the cost of jobs, the charge for burden which hitherto has been the difficult and uncertain part of cost accounting will be as accurate as the charge for direct labor. Furthermore, the use of equipment rates, in effect a *precision method* for the important part of overhead expense or burden, requires no more work in a cost office than the application of a rate which contains only part of these charges.

There are two good reasons for saying that a scientific machine rate is a development of tremendous importance in cost accounting practice. The first is that referred to in the opening paragraph of this article, namely that it is essential when scientific management is introduced that there should be an *exact* measure of the saving which is effected by it. The literature on this subject has not thus far made a sufficient recognition of the very important fact that if an operative reduces the time on a given job from ten to seven hours, for example, he has not only saved three hours at his wage rate, but also three hours of the rate for the machine tool which he has used, and three hours of general burden. As will appear from the table annexed to this article, these overhead costs are frequently more important than the direct wage which has already received so much attention.

Cost accounting practice, moreover, which analyzes burden charges as described in the foregoing paragraphs would naturally make a very precise account of the increases in overhead expense of any kind. In some cases in connection with the introduction of scientific management, these increases would be in a particular department, and would operate to increase the burden which would be disposed of as a machine hour rate for the tools in that department. Usually, however, the additional charges would operate to increase the general burden, which is one of the most important and at the same time, one of the most elusive elements of manufacturing cost.

A Measure of Loss Due to Slack Production and Inefficient Operation

The second reason for attaching so much importance to a

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scientific machine rate is that it makes possible an accurate measure of the loss due to slack production or interrupted operation. This is perhaps more important than the improved accuracy of cost records referred to above. When the board of directors is gathered at the end of the year, or once in six months, to learn about the results of the period under review, they do not often consider such detailed matters as the cost of individual orders. On the other hand, they are always interested in any explanation which the manager has to make about losses that are due to curtailment of manufacturing operations.

The directors at such times would value more than anything else a clear statement showing *how much* their company had lost on this account, especially if the details of the statement could be readily understood and readily proved by an analysis of the operating conditions. The big problems (in regard to manufacturing) which the directors have to settle are to make an efficient use of plant and equipment, especially if they are asked to decide on new additions to meet a probable volume of business. The new plant means an added investment, and it is of the utmost importance that the accounts should subsequently show to what extent this investment was utilized.

It is essential to distinguish clearly between losses or gains on machines actually made and sold, and losses due to slack production or inefficient use of equipment.

It must be borne in mind that the finished product has absorbed only the burden of the equipment actually used in its manufacture. It has not absorbed the burden of unused equipment or idle machinery. If the plant includes a foundry and the management decides to purchase castings, the idle foundry has contributed nothing to the product. It is obviously unfair to charge into the cost of goods the burden charges on the automatic machinery that may be idle because the management is buying and not making machine screws. If only three-quarters of the lathes run, the idle remainder have not helped machine parts actually manufactured, and although the plant may go into bankruptcy if it cannot utilize its equipment, the cost of the work actually done is not greater on that account.

The burden on idle machinery is no more a part of the cost of manufacture (unless due to enforced seasonal variations) than the burden on a shop owned by another corporation. When

there is a proper distribution and application of expense burden, only the burden is charged to cost which represents the equipment utilized in manufacture, and burden not applied remains as a balance to be charged direct to the loss and gain account at the end of a month, six months or a year. (See diagram page 27.)

This is readily accomplished through the means of burden accounts which collect by a very simple bookkeeping practice all of the charges in a given class, and receive credits as burden rates of the same kind as charged to the cost of product going through the works. The unearned burden in some cases may indicate an error which is to be corrected by using a more accurate rate in a subsequent period, but when proper records have been established, *the unearned burden is a clear loss*, and the balances of the burden accounts should be transferred directly to the profit and loss account.

Effect on Sales Policy

If the distinction is maintained between losses or gains on goods made and sold, and losses due to restricted output, the management will consider sales policies in a much more certain way than is possible when the facts are obscured in the haze of average costs, calculated on varying volumes of product. In respect to burden it is frequently true that costs figured as averages vary beyond all hope of comparison as the volume of output goes up or down.

When a cost accounting practice is maintained that distinguishes carefully between prime costs for material and labor, (which vary almost directly with the volume) and overhead charges or burden, the managers can see exactly in times of slack production at what price they can take any work that is offered and get something to carry the burden of the shop, in addition to the direct cost of labor and material. This, it must be admitted, is to some extent a matter of policy, for it may be better to hold a price and restrict output, rather than break the market by quoting prices that will give temporarily a little additional profit.

A Measure of Manufacturing Efficiency

Whatever the effect on sales policy, good cost accounting,

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including correct burden distribution, is a matter of enduring importance from the point of view of manufacturing. Changes in volume may completely obscure gains or losses in efficiency, and render comparative costs of similar jobs impossible from season to season, solely because of the variations in the amount of business done. Exact costs, comparable under all conditions, are not to be secured unless the burden charged to production is only that appertaining to the equipment that is actually at work.

From the manager's point of view, the significant fact is that the burden, which it is proposed to apply through a series of equipment rates, is not appreciably less when the operating schedule of the plant is reduced. It is true that power charges may be slightly less, but the fixed charges for building space, interest, insurance, taxes, depreciation, and in some circumstances for repairs also, are no less when the machines are idle. The manager of a machine shop cannot make a greater mistake in figuring costs than to charge a higher burden in any form whatsoever for the operation of part of his equipment, because the rest of it is temporarily idle, or a higher rate for a smaller labor force because the plant is working on part time. These differences which have always attracted the attention of observing managers are almost entirely clear loss or waste, and should be recognized as such and charged directly to the profit and loss account.

A Practical Example

The practical manager who regards these ideas as too theoretical will do well to inspect the following list which shows the results of working out a machine hour rate for direct operating burden in a plant operating about one hundred and fifty machines.

| <i>Number of Machines</i> | | <i>Rates in Cents</i> | <i>Number of Machines</i> | | <i>Rates in Cents</i> |
|-------------------------------|---|---------------------------|-------------------------------|---|---------------------------|
| 6 | @ | 1.5 | 2 | @ | 14 |
| 4 | " | 2.0 | 11 | " | 15 |
| 9 | " | 2.5 | 1 | " | 17 |
| 4 | " | 3.0 | 3 | " | 18 |
| 6 | " | 4.0 | 1 | " | 19 |
| 2 | " | 5.0 | 1 | " | 20 |
| 4 | " | 6.0 | 1 | " | 22 |
| 10 | " | 6.6 | 4 | " | 23 |

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| | | | | | |
|----|---|------|---|---|----|
| 12 | " | 7.0 | 3 | " | 24 |
| 12 | " | 8.0 | 2 | " | 25 |
| 7 | " | 8.7 | 1 | " | 26 |
| 4 | " | 9.0 | 1 | " | 29 |
| 3 | " | 9.5 | 2 | " | 30 |
| 10 | " | 10.0 | 1 | " | 47 |
| 3 | " | 11.0 | 1 | " | 52 |
| 13 | " | 12.0 | 1 | " | 76 |
| 2 | " | 13.0 | | | |

If one is disposed to criticise the minute division that has been made, such as having rates at 8c, 8.7c, 9c, 9.5c, and 10c, it should be borne in mind that there is practically no more work in the cost accounting department in using five rates instead of two. Moreover, if an effort is made to combine some of these rates, it is exceedingly hard to say which rates should be raised and which should be lowered. If five rates like those mentioned above should be brought together, some of the rates would be at least 15% out of the way. Such an error is altogether too large to be tolerated unnecessarily, when one is seeking for really accurate costs.

At the plant where these rates are in force the burden for erecting hands, including the charges for floor space, crane service and supervision, was *five times the rate for bench hands*. In addition to these rates every employee participates in a general burden which includes superintendence, managers, drafting, cost accounting, and all general charges, except those connected with selling expenses.

Inaccuracy of the Old Methods

The results which have been secured in working out these machine rates need only be stated to a practical man to show the violent inaccuracy which there must have been in cost accounting when overhead charges were applied as a percentage of productive labor, or even on a uniform man-hour basis. The following figures will supply a vivid illustration of the inaccuracy of the old method:

| <i>Job No. 1</i> | | | <i>Job No. 2</i> | | |
|--|---|--------|--|---|--------|
| 5 hours labor @ 28c | = | \$1.40 | 5 hours labor @ 28c | = | \$1.40 |
| 5 hours burden on the average plan @ 30c | = | 1.50 | 5 hours burden on the average plan @ 30c | = | 1.50 |
| Total cost | = | \$2.90 | Total cost | = | \$2.90 |

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At the same wage rate the two jobs show the same cost because they took the same time, although job No. 1 may have used a machine worth 3c per hour and job No. 2 a machine worth 24c per hour, or even one worth 50c per hour or more. Under these conditions, and assuming a general burden rate of 10c per hour, the true cost of these two jobs was as follows:

| <i>Job No. 1</i> | | <i>Job No. 2</i> | |
|------------------------------|---------------|------------------------------|---------------|
| 5 hours labor @ 28c | = \$1.40 | 5 hours labor @ 28c | = \$1.40 |
| 5 hours machine rate @ 3c | = .15 | 5 hours machine rate @ 24c | = 1.20 |
| 5 hours general burden @ 10c | = .50 | 5 hours general burden @ 10c | = .50 |
| Total cost | <u>\$2.05</u> | Total cost | <u>\$3.10</u> |

This is a very conservative comparison. If job No. 2 required a machine worth 60c per hour, the cost would have been \$1.40 + \$3.00 + \$.50 = \$4.90. The percentage on labor method, or a straight man-hour rate in the shop, would show that these three jobs had the same cost, although as a matter of fact in the second case the cost was 151% and in the third case 239% greater than the first.

Perhaps the best thing that can be said about cost accounting practice by machine hour methods is that it does not require any more work than any of the older methods that have been well developed as a means for taking out costs. At the plant from which the above illustration is drawn, it is not expected that there will be any increase in the cost accounting force for the operation of the plan as outlined. Of course, if a plant with an under-developed cost practice, or none at all, starts to make improvements in a wholesale way, it must expect to increase the overhead charges. If this increase is wisely planned, it is sure to be a money making expenditure.

Mass Production and Automatic Machines

As noted earlier in this article, there are some conditions, of course, under which a machine rate cannot be used to distribute burden, *but the underlying principle of collecting all burden charges for each production center is sound, whatever method may be used for distribution.* Some operations can best use a process rate, which includes labor and accessory supplies

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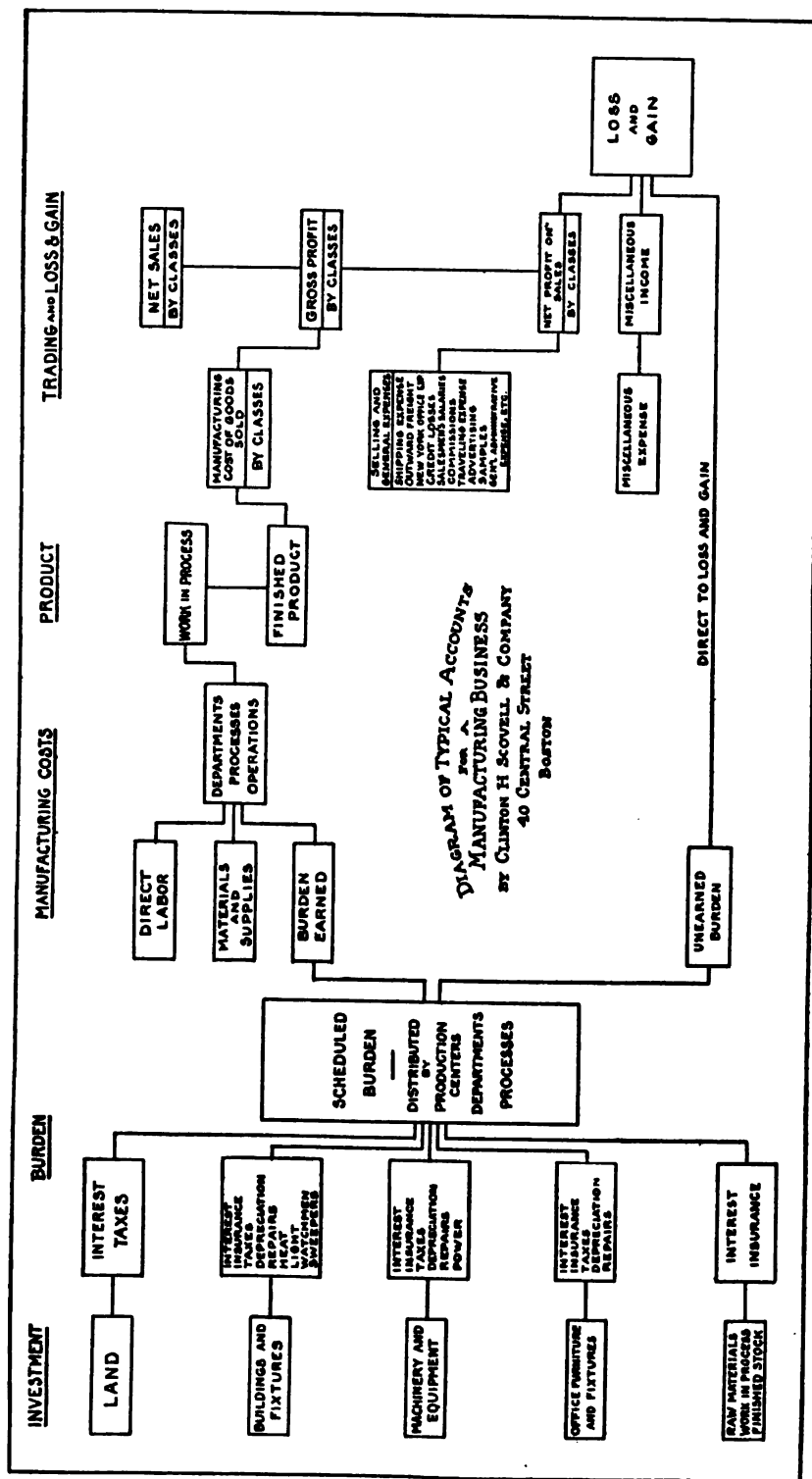
as well as burden. This method is particularly applicable to mass production, or any work that is not made on successive and clearly distinguished manufacturing orders. The application of overhead charges, however, can be made through a process rate strictly in accordance with approved principles of burden distribution.

Automatic or semi-automatic machines present a troublesome problem of burden distribution, especially as the burden is usually far more important than the labor as an element of manufacturing cost. This problem has been handled at a plant operating several hundred automatic machines by a plan of efficiency charts, which provide for charging to the job the cost of the effective operation of the machine. Cost accounts under this plan measure with great precision the loss due to slack production, or careless attention from the operator.

Conclusion

There are still some managers who do not realize the importance of a good cost and accounting practice, but the knowledge it supplies is undoubtedly a valuable business asset, as well as a powerful aid to efficient management. The best possible evidence for this statement is that progressive and successful manufacturing enterprises are making liberal expenditures for work of this character.

The present day trend of business is undoubtedly in the direction of a more exact and scientific knowledge of every important detail. Success by rule of thumb, or from energy and enthusiasm alone, is becoming more and more impossible. "The man who knows and knows he knows" is the man who wins.



Efficiency in Municipal Accounting and Reporting*

BY W. D. HAMMAN

Deputy City Auditor of Los Angeles

Accounting in some form is as old as civilization. Commercial accounting has reached a stage entitling it to be classed as a science; municipal accounting, however, is still in the elementary stage and much of it is far removed from the realm of guesswork, while efficient municipal accounting is as yet in its swaddling clothes.

The financial affairs of a municipality concern every citizen, but "what is everybody's business is usually nobody's business—but the politician's." The modern efficiency idea is that the function of a municipality is one of business, not politics; that a city government is analagous to a big commercial corporation, each citizen and taxpayer having the status of a stockholder. As a shareholder in a private corporation insists on an up-to-date accounting system, so the citizen-stockholder should demand a full statement of all the facts. An efficient system of accounting and reporting will show what results are accomplished and what value in property or service the taxpayer's dollar buys.

Assuming that we are all in the elementary class, let us consider a few fundamental principles in municipal accounting.

Accounting in its higher aspects is a comprehensive term and includes organization, administration, and operation. An account, as defined by SPRAGUE in his *Philosophy of Accounts*, is a "systematic statement of financial facts of the same or opposing tendency, leading to a conclusion." There are few municipal accounts, so called, that measure up to this standard; lacking system and proper classification of items, the "conclusion" formed may be erroneous and tend to conceal rather than reveal facts.

An accountant, as viewed by the man in the street, is a "bookkeeper out of a job." Bookkeeping in ordinary practice is largely mechanical. A mechanical bookkeeper learns to stick certain pegs in certain holes, as has been done by those before him, but an accountant analyzes the facts, determines *why*, and follows a system of reason and logic, rather than one of pegs and holes.

* A paper read before the California League of Municipalities.

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"A public accountant" says DR. WM. ALLEN in *Efficient Democracy*, in a critical vein, "is an itinerant bookkeeper who sells his time to tell whether a stationary bookkeeper's addition and classification are correct or incorrect." Continuing in the same humorous vein, DR. ALLEN says: "An itinerant bookkeeper who demonstrated at a state examination that he was able to post books and add columns correctly was permitted to call himself a certified public accountant."

Seriously, the C. P. A. degree is one of honor and commands the highest regard, but certified accountancy has heretofore given scant attention to municipal accounting. There being no operative results capable of being assembled and analyzed in a profit and loss account, the certified public accountant frequently fails to show tangible results in his analysis of municipal accounts.

This logically leads to a consideration of the differences between private and public accounting. "The differences between public and private accounting," says LEONHAUSER in his *Handbook of Municipal Accounting*, "are not differences in method; they are rather differences in the subjects concerning which information is needed." The private corporation engages in business for profit; it is not a "welfare agency" except for its own stockholders; they ask and have a right to expect results, profits and dividends. The profit and loss account as perfected by modern accountancy tells a complete history of corporation activity, its losses or gains. However, in the municipal corporation, which rarely engages in business for profit, the chief concern is, or should be, the economic benefits to the public in general and the welfare of the individual citizen. This being the case the city's profit and loss account is non-existent; the city may indeed make gains or suffer losses, but these appertain rather to the good or evil economic results to its citizens, which are difficult to measure in dollars and cents. However, it must not be inferred that there is no way of measuring governmental business.

Public accountants frequently refer to municipal bookkeeping as "cash book accounting," and the criticism with a few exceptions is just. Ordinarily a record of the flow of cash into and out of the treasury is the only thing revealed, and the municipal account when kept on the cash book system does not tell what the interested citizen and taxpayer should know of extravagance

and waste on the one hand or of economy and efficiency on the other.

A record of receipts and disbursements, even when kept in more or less detail, tells a rambling and disconnected story, from which the public can extract little of interest or real value.

In justification of this method it is frequently said that the city business is like that of a bank, which reduces its transactions to a cash basis. There is a similarity, but it is more apparent than real; the bank, while recording its various forms of credits as cash receipts and disbursements, nevertheless depends upon its profit and loss account for a knowledge of results. Imagine a cashier reporting to stockholders or directors the deposits received and cheques paid to convey an idea of success or failure of the banking business.

There are other serious objections to "cash book accounting." It takes no account of revenues accrued or expenses incurred until they reach the cash stage. Work done is misrepresented, because it fails to include goods used or services rendered last year, but paid for this year, or payments last year for services or goods used this year. It does not afford a continuous and intelligible record of property acquired, payment for which extends over a period of years. An appropriation for the fiscal year is made, and against that the payment is entered; this eliminates the fund account; and the same method is repeated in a subsequent year.

The cash book system is in almost universal use, but in some progressive cities, notwithstanding its imperfections it has been made to serve a valuable purpose, with a proper classification of receipts and expenditures into functional groups and by objects of expenditure, which enables a comparison with a corresponding monthly or yearly period, making it of high administrative value. Such comparisons when arranged in parallel columns, with increase or decrease in dollars or per cent, achieve the maximum of good in such an imperfect system. A comparison with like activities in other cities of similar rank affords a fair idea of the relative economy and efficiency.

Although single entry bookkeeping has been discarded by the commercial world, except in small shops and stores, yet cities, the volume of whose business runs into millions, are in the majority of cases content to follow the primitive method of

Efficiency in Municipal Accounting and Reporting

simple record keeping. A chart recently published shows less than twenty American cities that submit a trial balance. A simple control account with cash or with treasurer will suffice to bring all ledger accounts into equilibrium for double entry purposes. Entries not involving cash nor affecting "fund accounts," if journalized and posted into same ledger, will not interfere with a perfect balance of the whole, provided the "city corporation" is debited or credited with the opposing asset and liability journal entries.

The defects of cash book accounting have been known for half a century. Until within the past score of years English cities have led in progressive municipal accounting. The so-called "expense and revenue system" of the British contained the nucleus of the new system; but our most modern American cities, actuated by the spirit of economy and efficiency, have so perfected it as to justify its classification as a science.

Briefly stated the new expense and revenue system embodies the principles of the commercial profit and loss account. The expenses of the city as a whole are assembled on the debit side and the revenues on the credit side; the excess of expenses over revenues is shown as a deficit, while the excess of revenues over expenses is shown as a surplus. In connection with this, but really forming a part of it, is what is called the accrual system, which takes into account all amounts due the city, as well as all amounts owing by the city. This is also sometimes called the asset and liability system.

There are four well recognized ways in which the property and liabilities of a municipality can be affected, *viz.*:

- (1) They may be increased or decreased by cash transactions.
- (2) They may be increased or decreased by credit transactions.
- (3) Assets may be decreased by depreciation and liabilities increased by reserves set up to cover depreciation.
- (4) Assets may be decreased by loss of property or defalcation, or by setting up the necessary reserves to cover such losses.

The cash book system recognizes only the first way, while the asset and liability system comprehends them all. All anticipated revenues such as taxes, licences, franchise income, etc., which are estimated on the basis of previous years' experience,

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for budgetary purposes are set up in accounts indicating what ought to be received. The amounts when collected are credited so that the excess or deficit may be shown. This enables the collection of much revenue that might otherwise be overlooked. Accounts of delinquent taxes, sinking funds, etc., together with contingent liabilities such as outstanding orders and contracts, are not ignored. The general appropriation account will show unappropriated or over appropriated funds. Without this full record of financial facts, administrative officers cannot have an intelligent basis for action, nor can they know how the prescribed financial programme is working.

Of course cash transactions must be recorded as in the old system, but the classified receipts and payments are summarized, journalized and posted into the general ledger. The cash or treasurer account in the general ledger operates as a control over the fund ledger. The general ledger may be divided into any required number of individual ledgers such as contract ledger, property ledger, etc., each self balancing and controlled by an account in the general ledger.

What has been said applies to the general accounting system in the office of the auditor or controller. The departmental accounting should be in perfect harmony with the central system.

Efficiency in municipal affairs is a vital issue today, but many have only a vague idea as to what it is or how it is to be secured. As an object, efficiency is simply getting the most value for the least money. The matter of determining the degree of efficiency or inefficiency is almost wholly an accountancy proposition. The asset and liability system embodies all the elements of efficiency accounting, but to be of greatest value expenditures must be subjected to further analysis to derive more specific details, making it clearly analogous to what is known as "cost accounting" in the commercial world. The fundamental principle underlying this system is cost analysis and the separation of its primary elements into a number of logical groups, and determining the unit cost of each.

All administrative officers must act. Specific knowledge is necessary for intelligent action. They should know the cost by organization units; cost by activity; cost by character of expenditure; cost by objects purchased.

The determination of unit costs is the highest achievement in

Efficiency in Municipal Accounting and Reporting

accounting science, and clearly deserves the name "efficiency accounting." A unit is defined as "any given quantity with which others of the same kind can be compared or measured." "There can be no unit for the man who has no desire to know." The common units are per capita and per cent, but perhaps the most serviceable is the *per dollar* unit. Efficiency accounting will determine such questions as unit cost of collecting a dollar in revenue; unit cost of making an arrest; unit cost of a square yard of surfaced street; unit cost of delivery to consumer per 1,000 gallons water, etc. In personal service on measurable work, it will determine what per cent of value an employee renders for each dollar paid out of the municipal cash box.

Efficiency in municipal affairs is not possible unless there be an adequate accounting system. While accountancy cannot furnish energy and intelligence, it can and does expose inefficiency, dishonesty and extravagance and renders possible economy, efficiency, and resultant good government.

A municipal audit is defined to be, "an official examination of accounts to determine their accuracy and validity as a charge against specific appropriated funds." Checking is a necessary part of an audit, but if this is confined simply to determining if the recorded entries agree with the vouchers, as in most public auditing done under the direction of the grand jury, it usually fails to serve any substantial purpose.

A simple definition of an auditor is "one who audits." From this it must necessarily follow that one who does not audit is not an auditor, even though he may have the title and draw pay as auditor. There are two kinds of audits—a pre-audit and a post-audit. HERBERT SANDS calls the latter "post mortem audit," which is a very appropriate name, as it usually involves only the viewing and passing on the "remains"—finding out how, when, and where goods or money has been taken, and possibly prescribing a remedy. The post-audit is inefficient, as the crook can easily conceal his dishonesty by omitting or destroying incriminating evidence. A pre-audit is the efficient method and typifies "prevention" as compared with "cure" in the post-audit.

The pre-audit as applied to expenditures is now in quite general use in many large cities, but comparatively few have so far attempted to pre-audit receipts, although the latter is simpler and more easily effected. A pre-audit of expenditures is as-

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sured by requiring every expenditure for goods or personal service to be preceded by an authorization from the proper board, commission or legislative body. If this is done the duty of an auditor, aside from verifying computations and extensions, is to determine whether the expenditure conforms to the authorization. The pre-audit of receipts is accomplished by the auditor or controller issuing the financial stationery to the revenue collecting officer and holding him responsible for the proper use of the official receipts. This plan definitely fixes responsibility and while it is not absolutely "knave-proof," it serves as an effective check on dishonesty.

Perhaps ten dollars is lost in property where one dollar is lost in money to every municipality. The concealment or removal of personal property of a municipality is so easy that it is not astonishing that losses are frequent. In a large eastern city a steam yacht worth \$10,000 was stolen and never recovered; in another city two houses belonging to the municipality mysteriously disappeared; in another city an automobile vanished from sight. If such things are possible with houses and steam yachts we may only conjecture what can happen to more portable property.

A property audit consists of a charge to the officer given its custody and an annual inventory-audit thereafter, holding the custodian responsible for any shortage. Property worn out or valuable only as junk should be "surveyed" and condemned, so that proper credit may be given to the custodian. Simple and businesslike as this appears, few cities thus audit their property.

Such negligence as many municipalities display in these matters would bankrupt any corporation that did not have behind it unlimited resources.

Most large cities publish a report annually, some publish one quarterly, while several do so monthly. It goes without saying that a municipality's report should be a good witness and "tell the truth, the whole truth and nothing but the truth." Few published reports measure up to this standard. Some cities with faulty accounting methods try to classify and arrange their reports on modern lines, trusting to conceal the shortcomings of their accountancy methods. Such tactics may mislead the confiding taxpayer, or even the novice in fiscal matters, but the financier and the bond expert can usually see through the thin veneer.

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The prime requisites of a good report are promptness, accuracy and completeness. The National Municipal League suggests that detailed accounts be divided into two classes, *vis.*: (1) Operative accounts showing costs of municipal administration and municipal revenues available to meet expenses, (2) Proprietary accounts, showing assets and liabilities.

Classification of all accounts into functional groups—such as general government; protection to life and property; health and sanitation; highways, charities and corrections; education; recreation; municipal industries—has been adopted by the federal and state government in the interest of a uniform system of accounting and reporting, and is now generally followed by larger cities still on the cash book system. This plan, however, is not altogether suitable to the expense and revenue system and hence reports of cities on the new system do not adhere to the National Municipal League's plan.

A plain distinction should always be made between expenditures on capital account, usually called "outlays," and expenditures involving maintenance, operations, etc., usually termed "expenses." A municipality's expenditures for outlays will vary from year to year owing to differing needs; but the expenses of a city should not vary much from year to year except to increase with population; and then the percentage should differ only slightly.

I know that there are those amongst the older writers on accounting who maintain that a municipality's chief asset is its power of confiscating property within its limits through taxation, and that such an asset cannot be valued. While it is true that the bond purchaser does not regard the city's tangible property as a realizable asset for bond payments, yet the more property a city owns the less it will have to buy, and this indirectly bears on a municipality's borrowing capacity. Those who hold this view do not contend, however, that what the city owns and what it owes should not be assembled in some way to show the excess of assets over liabilities. The municipal balance sheet only can provide this necessary statement of financial facts.

Every municipality as a part of its annual report should exhibit a balance sheet, showing classified summaries of all the city owns as assets and everything the city owes as liabilities. This should be in at least two sections—capital, balance sheet, and

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general or fund balance sheet. The capital assets are fixed properties such as real estate, machinery and equipment, sinking fund investments, and cash balances in bond funds. As opposed to these would be bonded and other outstanding debts appertaining to these fixed properties. Excess of assets over liabilities may be properly shown as "city corporation" or simply as capital surplus.

In the general account section should appear as assets the cash in fund accounts, delinquent taxes or other accounts receivable due the city. As opposed to these would be advance payment of taxes, outstanding demands, or other debts and encumbrances against fund cash. The excess of assets over liabilities may be shown as revenue surplus or simply as surplus. Of course if there are trust funds another division must be made which will show the cash on hand as an asset and the trust fund account as a liability.

The municipal balance sheet is a modern innovation, and some accountants err in the making of it; this is due to confusing the cash book fund entries appearing as debits with the ledger accounts appearing as credits; the error consists in showing the fund accounts as assets. The balance sheet represents the ledger accounts, where all balances appear on the side opposite to those in cash book. The difficulty grows out of the inability to distinguish between a fund which is an asset, and a fund account which is a liability. The municipal balance sheet should not be one of memoranda, but should be a true summarized abstract of the general ledger trial balance, and hence must be in perfect equilibrium.

In conclusion it may be appropriate to say that the awakened public interest in municipal activities, due to the work of efficiency commissions and bureaus of municipal research, is a hopeful sign of the new era in municipal administration, which will throw the old inefficient order into the discard.

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EDITORIAL

Integrity of Investment

The members of the New York stock exchange recently adopted a resolution calling for the appointment of a special committee to assist in measures which will "tend to increase the safety and integrity of American investments and at the same time afford every encouragement to legitimate enterprise."

The action of the exchange is undoubtedly wise and timely. Such a body should have a fuller appreciation of the difficulties combining the two objects sought than some of the legislative bodies which have attempted to afford protection to investors without adequate consideration of the effect on legitimate enterprise; and as the exchange possesses considerable powers in such matters it has the means of testing the efficiency of measures which the committee may recommend. Moreover, quite apart from its powers the exchange can exercise an important moral influence and can establish standards which will in a large measure be accepted by corporations and promoters even without legislative authority. Indeed, we believe that the healthiest development in such matters can be obtained by the creation of a strong public sentiment in favor of such methods as

will best protect investors before they are crystalized into law and made legally binding by statutes.

The subject with which the committee is called on to deal is divisible into two parts: First, the safeguarding of the issue of securities; and, second, the protection of the holders of securities after they have been issued.

As regards the issuance of new securities, the present English company law is, we believe, generally accepted by students of the subject as embodying a fairly satisfactory provision for the protection of investors. The main features of this law are the requirements for a full disclosure of all important contracts affecting the company, of the interests of the promoters and directors in the business to be acquired or in the promotion or underwriting of the issue, and the explicit rules as to the responsibility for representations made in the prospectus whether on the faith of reports of others or not, different rules of course applying in the two cases. In view of the general interest in this question we are printing a copy of a typical English prospectus (see page 40) which illustrates the working of the act and which will repay careful study.

The exchange has power to make similar requirements as to disclosure in connection with any securities which it may be asked to list, and whilst it cannot make the promoters legally liable for failure to make full disclosure its influence should be sufficient to insure that its rules shall be generally observed.

The responsibility for statements in a prospectus would seem to be a question which can only be dealt with by legislative enactment, but the exchange should be able to render valuable service in securing legislation which will be practicable and not so drastic as to hamper new and legitimate enterprise.

Turning to the protection of holders of securities after they have been issued, the exchange should be able to deal with this question perhaps even more effectively than could be done by legislation. It is in this feature that the existing English law is the least satisfactory and the reports of the best English companies are meagre in comparison with those of the best American companies. A statute cannot prescribe more than a standard which all companies would be fairly required to adopt, and where a statute exists there is a natural disposition not to go beyond statutory requirements. In the resolution now under con-

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sideration reference is made to the desirability of greater publicity and fuller and more frequent reports of operations than has been customary with many companies in the past. Undoubtedly much can and should be done to bring the general practice of corporations closer to the standard set by the best companies in regard to publicity. At the same time it must be remembered that all companies cannot safely adopt the same standard. Companies engaged in competitive business cannot afford to disclose details of their business too explicitly, and information so disclosed may be more valuable to competitors or customers than to stockholders. This consideration has greater weight where a company is engaged in only one or two lines of activity than where its interests are more diversified. Again, while more frequent reports of operations are in many cases desirable it should be realized that, particularly in businesses of a fluctuating character, too frequent reports may easily be misleading, though quite truthful, and more harmful than beneficial to the average stockholder.

* * * * *

We have dealt thus far with the general aspects of the subject, but in both branches it has a special interest for accountants.

If those concerned in the issuance of securities are held to a strict responsibility for the representations made in connection therewith provision must be made for limiting that responsibility as to matters not within their personal knowledge. The natural limitation is exemption where representations are based and are stated to be based on reports of disinterested experts and the most important of such representations are often, if not usually, those as to past profits and present financial position, the natural basis for which is an accountant's report. Again, in the matter of subsequent reports, there is a steadily growing realization of the necessity for independent verification of published statements, and particularly annual statements, such as has been made compulsory in England and in many British colonies. It is to be hoped that the committee will lend its support to this movement and especially to modifications in the present practice calculated to strengthen the hands of auditors. The practice of having annual audits having been somewhat reluctantly adopted there is a disposition now to expect too much from them, a disposition for which the extravagant claims of some

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accountants seeking business are doubtless in a large measure responsible. There will always be limitations upon the protection which an audit can afford, but these limitations would be greatly reduced if auditors were made more independent of the officers and directors of a company by provisions for their election by stockholders and for opportunity for them to be heard by the stockholders before they could be supplanted, such as are contained in the existing English law. It is sometimes argued that such provisions would be ineffective because of the perfunctory character of stockholders' meetings, but if an important issue should arise between auditors and directors of a public company the press would be interested even if the stockholders should not be; and moreover, there has been a decided tendency towards more real and effective stockholders' meetings in the last few years. Directors might still be able to control the election of auditors, but if they realized that should a serious difference arise between them and the auditors the auditors could place it before the stockholders they would refrain from forcing an issue unless reasonably sure of being able to sustain their position at the bar of public opinion.

The committee is called on to deal with a subject of wide importance and the results of its investigations will be awaited with sympathetic interest by the whole accountancy profession.

The prospectus referred to is as follows:

A Copy of this Prospectus has been filed with the Registrar of Joint Stock Companies in Scotland

The Subscription List will open on Monday, the First day of July, 1912, and will close on or before Wednesday, the Third day of July, 1912

THE SCOTTISH IRON AND STEEL COMPANY LIMITED

[Incorporated under the Companies (Consolidated) Act, 1908]

SHARE CAPITAL - - £750,000

DIVIDED INTO

300,000 Six per cent Cumulative and Participating Preference Shares of £1 each

(Ranking also as regards Capital in priority to the Ordinary Shares), and
450,000 Ordinary Shares of £1 each

Editorial

£300,000 Five per cent Redeemable First Mortgage Debenture Stock

DEBENTURE STOCK

The mortgage debenture stock will be secured by conveyances of the company's heritable property to the trustees for the debenture stock holders and by a deed of trust relative thereto. It will be repaid at 100 per cent not later than 31st December, 1934 by a cumulative sinking fund of $2\frac{1}{2}$ per cent, to be applied annually to the redemption of the stock by purchases when obtainable under 100 or by drawings at that price. The amount payable to meet interest and sinking fund in respect of the year 1912 will be £15,000 (representing one-half year's interest and a whole year's sinking fund) and in each subsequent year £22,500. In addition to this, the trust deed provides that after paying the 6 per cent cumulative dividend on the preference shares and before paying any dividend on the ordinary shares, the sinking fund will be increased by a further $1\frac{1}{4}$ per cent per annum (£3,750) of the amount of the debenture stock (£300,000), out of the surplus profits of the company. The company further reserves the right to increase the payments to the sinking fund in any year. In the event of a voluntary winding-up for the amalgamation or reconstruction of the company, the stock will be repaid at par.

PREFERENCE SHARES

The preference shares will carry a fixed cumulative preferential dividend of 6 per cent per annum, with the right to one-fourth of the profits in every year remaining after provision of a non-cumulative dividend at the rate of 6 per cent on the ordinary share capital.

The preference shares will also rank as to capital in priority to the ordinary shares, and in the event of liquidation, after the ordinary shareholders have been paid the par value of their shares, the two classes of shares shall rank equally until the holders of the preference shares have received an additional 5 per cent on the par value of their shares. Thereafter all remaining assets shall belong to the ordinary shareholders.

ORDINARY SHARES

The whole of the present issue of ordinary shares will be taken by the vendors in part payment of the purchase price of their businesses.

The dividend on the ordinary shares is, by the articles of association, restricted to 10 per cent per annum, payable out of the profits of any one year, until a special reserve fund amounting to £50,000 shall have been accumulated to secure the dividend on the preference shares, which, as provided by the articles, must be invested outside the business of the company.

Subscriptions will be received by the company's bankers:

THE LONDON CITY AND MIDLAND BANK LIMITED, Threadneedle Street, London, and Branches;

THE BRITISH LINEN BANK, Glasgow, Edinburgh, and Branches;

THE CLYDESDALE BANK, LIMITED, Glasgow, Edinburgh, and Branches;

For the Issue of £300,000 Five per cent Redeemable First Mortgage Debenture Stock at 95 per cent, and

150,000 Six per cent Cumulative Participating Preference Shares of £1 each at par

| Payable as follows: | Debenture Stock | Preference Shares |
|-------------------------------|-----------------|-------------------|
| On application | £5 0 0 | £0 1 0 |
| On allotment | 45 0 0 | 0 9 0 |
| On 12th September, 1912 | 45 0 0 | 0 10 0 |
| Total | £95 0 0 | £1 0 0 |

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The whole of the instalments may be paid on allotment only, and interest at four per cent per annum will be paid on such prepayments.

Bearer scrip will be issued after allotment, to be exchanged for registered debenture stock certificates after 1st October, 1912, the stock being transferable in amounts not involving a fraction of £1. Certificates for the preference shares will be issued in due course in exchange for bankers' receipts and fully-paid allotment letters.

The interest on the debenture stock will be payable half-yearly on 30th June and 31st December in each year, the first payment being on 31st December, 1912, calculated on the instalments from the respective dates of payment.

It is proposed to make the dividends on the preference shares payable in April and October in respect of the periods ending 31st December and 30th June in each year. The first payment will be calculated on the instalments from the respective dates of payment.

The preference and ordinary shareholders shall be entitled to one vote for every share held.

TRUSTEES FOR THE DEBENTURE STOCK HOLDERS

ARCHIBALD COLVILLE, Chairman of David Colville and Sons, Limited,
Dalzell Steel and Iron Works, Motherwell.
JOHN HENDERSON, General Manager, Clydesdale Bank, Limited, Glasgow.

SOLICITORS TO THE TRUSTEES

MACKENZIE ROBERTSON & Co., 176 St. Vincent Street, Glasgow.

DIRECTORS

| | | |
|---|---|---------------------|
| C. F. MACLAREN, Stenton Iron Works, Wishaw (Chairman), WM. DOWNS, Coats Iron Works, Coatbridge (Vice-Chairman), DAVID JOHN GARRETT, Waverley Iron Works Coatbridge, GEORGE B. BENNETT, Woodside Iron Works Coatbridge, ROBERT CRICHTON, Victoria Iron Works Coat- bridge THOMAS R. MILLER, Globe Iron Works, Motherwell, J. W. ARTHUR SPENCER, Phoenix Iron Works, Coatbridge, ROBERT WATERSTON, North British Iron Works, Coatbridge, WM. WYLIE, Clifton Iron Works, Coatbridge, | } | Iron Manufacturers. |
|---|---|---------------------|

BROKERS

BUCHANAN, GAIRDNER, and TENNANT, 19 St. Vincent Place, Glasgow.
EGERTON JONES and SIMPSON, 2 Copthall Buildings, London, E. C.

SOLICITORS

MOTHERWELL, M'MURDO, and MITCHELL, 10 Bank Street, Airdrie.

Editorial

AUDITORS

MOORES, CARSON, and WATSON, 209 West George Street, Glasgow, Chartered Accountants.

GRAHAMS and Co., 212 West George Street, Glasgow, Chartered Accountants.

SECRETARY—JAMES HAMILTON.

REGISTERED OFFICES (pro tem)—209 WEST GEORGE STREET, GLASGOW.

PROSPECTUS

The company has been formed for the purpose of acquiring, amalgamating and working as one concern the following businesses of malleable iron and steel manufacturers in Scotland with a view to securing economy of manufacture and administration:

| Name of Company or Firm | Name and Place of Works |
|--|---|
| ARCHIBALD BAIRD & SON, Ltd., | Cairnhill Iron Works, Coatbridge. |
| DOWNES & JARDINE, | Coats Iron Works, Coatbridge. |
| THOMAS ELLIS, Ltd., | North British Iron Works, Coatbridge. |
| GLENCAIRN IRON AND STEEL COMPANY, Ltd., | Glencairn Iron Works, Motherwell. |
| C. F. MACLAREN & COMPANY, | Stenton Iron Works, Wishaw. |
| HUGH MARTIN & SONS, | Coatbridge Iron Works, Coatbridge. |
| A. & T. MILLER, | Globe Iron Works, Motherwell. |
| JOHN SPENCER (Coatbridge), Ltd., | Phoenix Iron Works and Drumpellier Iron Works, Coatbridge. |
| WILLIAM TUDHOPE & SON, Ltd., | Crown Iron Works, Coatbridge. |
| THE VICTORIA IRON AND STEEL COMPANY, Ltd., | Victoria Iron Works, Coatbridge. |
| WAVERLEY IRON AND STEEL COMPANY, Ltd., | Waverley Iron Works and Rochsolloch Iron Works, Coatbridge. |
| WYLIE & COMPANY, | Clifton Iron Works, Coatbridge. |
| THE WOODSIDE STEEL AND IRON COMPANY, Ltd., | Woodside Iron Works, Coatbridge. |

DESCRIPTION OF BUSINESS—These firms and companies last year produced in malleable iron and steel about 225,000 tons.

Capital has been freely expended recently in the erection of the latest type of furnaces and machinery and in consequence the company will have a reserve capacity sufficient to meet the probable requirements of many years to come.

With two exceptions all the firms in Scotland which are strictly malleable iron manufacturers are included in this company, and with these two firms and a few others which make a small quantity of malleable iron as an adjunct of their larger business, arrangements are being made for a working agreement.

Malleable iron manufacture is one of the oldest metal industries in Scotland. Scotch iron has a first-class reputation both at home and abroad and the output is probably now equal to that of any district in the Kingdom.

The works proposed to be taken over have an excellent trade with the makers of boiler, gas, water, and steam tubes, rivets, bolts and nuts, the fencing and constructional trades, the Clyde and Belfast shipbuilders and engineers, locomotive builders, railway companies, and wagon builders.

EXPORT TRADE—The companies and firms have a considerable business with London, the various districts of England, Ireland, and the Continent

of Europe. In the export trade the various brands and trade-marks are well-known in Canada, Australia, New Zealand, South Africa, Straits Settlements, India, and the East generally.

In regard to specialties of the malleable iron trade, such as for government work at home and abroad, this locality has come into prominence during the last few years. Many of the firms about to be amalgamated by this company are on the British admiralty, war office, India office, and other official lists.

In consequence of the situation of these works in the heart of the coal and pig-iron district of the West of Scotland, with abundant supplies of fuel and raw materials, the company will be in a specially favourable position to compete on the best terms in home and foreign markets. The works being conveniently situated for the ports of Glasgow, Greenock, Adrossan, Leith, Grangemouth, and Bo'ness, enjoy exceptional shipping facilities to all parts of the world.

The present managers of the various companies and firms are being retained by the new company, so that continuity in business and efficiency in manufacture are assured.

VALUATION OF PROPERTIES ACQUIRED BY THE COMPANY—The works, including ground, buildings, and fixed machinery and plant of the various firms and companies, have been valued by Messrs. Fuller, Horsey, Sons, and Cassell, Valuers, London, who have had a long and intimate connection with works of this description, and have practical knowledge of the trade, at the sum of £518,062.

The loose plant and tools have also been valued by the same valuers at £57,314.

The following is a copy of their certificate:

FULLER, HORSEY, SONS, and CASSELL. 11, Billiter-square
London, E. C., 21st June, 1912

CERTIFICATE
To the Directors of The Scottish Iron and Steel Company, Limited:

GENTLEMEN—In accordance with your instructions, we have attended at the undermentioned iron and steel works, rolling mills, and other properties, and have made a survey and valuation of same, together with the fixed and movable plant and machinery therein:

(1) Waverley Iron and Steel Works at Coatbridge, and a neighboring disused quarry used as a tip; (2) The Rochsolloch Iron and Steel Works; (3) The North British Iron Works at Coatbridge, together with an adjoining block of dwelling houses and tenements; (4) The Phoenix and Drumpellier Iron Works at Coatbridge, and a block of tenements in Phoenix Square, Coatbank Street; (5) The Globe Iron and Steel Works at Motherwell, together with certain tenements, a shop, and a fully licensed store; (6) The Coats Iron and Steel Works, situate in Coatbank Street, Coatbridge; (7) The Woodside Steel and Iron Works, situate at Langloan, near Coatbridge; (8) The Stenton Iron and Steel Works, situate at Wishaw, together with a row of 28 cottages in Alexander Street; (9) The Victoria Iron and Steel Works at Coatbridge; (10) The Clifton Iron and Steel Works at Coatbridge; (11) The Crown Iron Works, situate in Main Street, Coatbridge; (12) The Cairnhill Iron and Steel Works, situate at Calder, near Coatbridge; (13) The Glencairn Iron and Steel Works, situate at Flemington, near Motherwell; (14) The Coatbridge Iron Works at Coatbridge.

Each of the foregoing properties is held in perpetual feu, and is subject to a feu duty or duties amounting in the aggregate to £1, 621 8s 3½d per annum, in some cases with duplications and nominal casualties.

We are of opinion that the fair value as a going concern, as on 1st January, 1912, of the above-mentioned iron and steel works, rolling Mills, and other properties, together with the whole of the fixed plant, machinery, and fixtures, loose plant, tools, utensils, patterns, and other

Editorial

movables, is the sum of Five Hundred and Seventy-six Thousand Two Hundred and Seventy-six Pounds (£576,276), divided as under:

| | |
|--|----------|
| Land, buildings, and fixed plant and machinery ... | £518,962 |
| Loose plant, furniture, patterns, and other movables | 57,314 |
| | £576,276 |

These figures are exclusive of any value for stock, stores, material, work-in-progress, registered brands, trade-marks, or good will.

We are, Gentlemen, yours faithfully,

(Signed) FULLER, HORSEY, SONS, and CASSELL.

The stock-in-trade of each firm at 31st December, 1911, has been carefully taken and verified both as to quantity and quality by a representative from another firm. The pricing of the stock has been carefully supervised by a committee of the vendors. This stock will be taken over by the company.

WORKING CAPITAL—It is calculated that the sum of at least £180,000 will be available as working capital out of the present issue after payment of the preliminary expenses. This sum the directors consider sufficient for the purpose of the business.

PAST PROFITS—The books of the firms and companies now proposed to be acquired have been examined by Messrs. Moores, Carson and Watson, Chartered Accountants, Glasgow, and Messrs. Grahams and Company, Chartered Accountants, Glasgow, and the following is a copy of their certificate thereon:

To the Directors of The Scottish Iron and Steel Company, Limited:

GENTLEMEN—We have examined the books of the following companies and firms: (1) Downs and Jardine, Coatbridge; (2) Thos. Ellis, Ltd., Coatbridge; (3) C. F. MacLaren and Co., of Wishaw; (4) Hugh Martin and Sons, Coatbridge; (5) A. and T. Miller, of Motherwell; (6) John Spencer (Coatbridge), Ltd., Coatbridge; (7) William Tudhope and Son, Ltd., Coatbridge; (8) Victoria Iron and Steel Company, Ltd., Coatbridge; (9) Waverley Iron and Steel Company, Ltd., Coatbridge; (10) Wylie and Co., Coatbridge; (11) The Woodside Steel and Iron Company, Ltd., Coatbridge, for the eleven years ending December 31st, 1911; and of Messrs. Archibald Baird and Son, Ltd., in so far as these relate to their business at Cairnhill, Coatbridge, for the four years ending December 31st, 1911.

The aggregate profits calculated to December 31st in each case, before providing for interest, depreciation, management salaries, and income tax were as follows:

| 1901, eleven businesses | 1907, eleven businesses |
|--------------------------|--------------------------------|
| 1901, " .. £80,308 10 3 | 1907, " .. £87,031 13 0 |
| 1902, " .. 64,623 18 9 | 1908, twelve " .. 53,402 19 10 |
| 1903, " .. 72,891 15 7 | 1909, " .. 36,652 18 0 |
| 1904, " .. 80,439 12 1 | 1910, " .. 32,279 11 7 |
| 1905, " .. 84,631 7 7 | 1911, " .. 75,412 17 2 |
| 1906, " .. 106,387 13 10 | |

The annual average of the profits of the vendor firms on the basis of eleven years' working of eleven businesses, four years' working of one business, and apart from the results of the Glencairn Iron and Steel Company, Ltd., a company which has only been working for one year, and whose books have not been examined by us, has been £72-18s 12s 9d.

The amount charged for maintenance and renewals before arriving at the above profits is equal to an average of not less than £28,000 per annum. In addition to this, the wages expended on maintenance

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and renewals have been charged to revenue, but it has not been possible to ascertain the amount thereof.

We are, yours faithfully,

GLASGOW, June 21st, 1912.

(Signed) MOORES, CARSON and WATSON, C.A.
(") GRAHAMs and Co., C.A.

During the years 1909 and 1910 exceptionally keen competition prevailed amongst local makers, and prices were for a time reduced to an unremunerative level. In addition to this, several of the works were for varying periods closed for alterations and reconstruction. The profits for 1911 have shown a satisfactory recovery, and it is anticipated that irrespective of any benefits from amalgamation, 1912 will show much better results.

The amount required to pay the interest on debenture stock and the fixed dividend on the preference shares is:

| | |
|---|---------|
| £300,000 first mortgage debenture stock at 5 per cent | £15,000 |
| 2½ per cent for redemption of debentures | 7,500 |
| £300,000 in preference shares at 6 per cent | 18,000 |
| | <hr/> |
| | £40,500 |

By reason of the economies hereafter referred to, coupled with the general improvement in the trade, it is considered that increased profits can be earned, which would mean additional dividends on the preference shares.

The works proposed to be taken over are at present fully employed, and the contracts already booked will keep them so for many months.

ECONOMIES TO BE DERIVED BY AMALGAMATION—The economies which can be effected by the consolidation of this trade are very marked. The profits obtainable can be largely augmented owing to the fact that the malleable iron industry is peculiarly fitted to benefit from improvements in methods of working, which are only rendered possible by amalgamation. The rolling of the many and varied sections and the range and dimensions in these sections involves frequent roll-changing in the mills, but under amalgamation this will be reduced to an absolute minimum, giving thereby:

(1) Greatly increased output from present plant in a given time, and consequent reduction in overhead charges.

(2) Saving in consumption of fuel.

(3) Less waste of metal due to much greater uniformity and regularity of work at furnaces and mills.

(4) The utilization of plant on lines to give outputs greater than are possible when working as individual firms.

The economies in expenditure on rolls and other plant will also be considerable.

The advantages of buying in larger quantities and the lessened competition in selling should tend to increase the margin of profit obtainable.

The businesses will be taken over as from the 1st January, 1912, the debts and liabilities to that date being discharged by the respective vendors, the benefit of the trading after that date accruing to the company, which will therefore benefit by the large rise which has taken place in the selling prices of its products since that date. The profits to the date at which the company is entitled to commence business will afford a fund available towards the payment of the preliminary expenses.

SECURITY FOR DEBENTURE STOCK AND PREFERENCE SHARES—As will be seen from the valuers' certificate.

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Lands, buildings, fixed plant and machinery represent a value of £518,962
 Loose plant represents a value of 57,314

To which has to be added the value of 576,276
 Goodwill, including value of brands and trade-marks 249,384
 Working capital, including stocks, provided by the present issue 180,000

Making a total of£1,005,660

or, excluding goodwill, etc., of £756,276. On the latter reduced figure it will be seen that the debenture stock is covered over two-and-a-half times, and the preference shares one-and-a-half times as to capital.

The following particulars are furnished in accordance with the requirements of the companies (consolidation) act, 1908:

A copy of the memorandum of association of the company, with the names, descriptions, and addresses of the signatories thereto, and the number of shares subscribed for by them respectively, is annexed to this prospectus, and forms part thereof.

The articles of association provide that the qualification of a director shall be the holding of shares of the company, whether preference or ordinary, of the aggregate nominal value of £1,000.

The provisions of the articles of association as to the remuneration of directors are:

ARTICLE 96. The remuneration of the directors, and their remuneration for services performed previous to the first general meeting, shall be determined by the company in general meeting.

ARTICLE 97. If any director shall be called upon to perform extra services and to make any special exertions for any of the purposes of the company or the business thereof, the company may remunerate the director or directors so doing, either by a fixed sum or otherwise as may be determined, and such remuneration may be either in addition to or in substitution of his or their remuneration as provided for above.

ARTICLE 117. The board may appoint any one or more of their number to be managing director, or general manager, or manager, or managing directors, or general managers, or managers, of the company, and may allow to him or them such remuneration in respect thereof, in addition to his or their remuneration as director or directors fixed in accordance with the preceding clause, as they think fit.

ARTICLE 118. The board may delegate to such managing director, or general manager, or manager, or managing directors, or general managers, or managers (provided that, in the case of a general manager, or manager, or general managers, or managers, he, or they, be a director or directors), all or any of the powers hereby made exercisable by the board except those relating to shares and borrowing, and any others as to which special provisions inconsistent with such delegation are herein contained.

The price payable by the company to the vendors, including price of stocks, is £956,508 9s 3d, of which £249,384 represents goodwill, payable to the respective vendors, as to £150,000 in fully-paid preference shares, as to £450,000 in fully-paid ordinary shares, and as to £356,508 9s 3d in cash out of the proceeds of the present issue. The purchase price payable to the vendors in preference and ordinary shares and in cash will be divided among them as follows, *viz.*:

Archibald Baird & Son, Limited, 8,435 preference shares, 26,513 ordinary shares, and £13,095 18s 6d in cash; Downs & Jardine 14,155 preference shares, 44,489 ordinary shares, and £21,319 17s 5d in cash; Thomas Ellis, Limited, 13,761 preference shares, 43,253 ordinary shares and £15,433 12s 6d in cash; Glencairn Iron and Steel company, Limited, 7,050 preference shares, 22,396 ordinary shares, and £11,378 1s 1d in cash; C. F. McLaren & Company, 13,081

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preference shares, 41,115 ordinary shares, and £21,134 1s 6d in cash; Hugh Martin & Sons 6,289 preference shares, 19,768 ordinary shares, £8,646 14s 7d in cash; A. & T. Miller 13, 758 preference shares, 43,243 ordinary shares, and £19,331 7s 1d in cash; ohn Spencer (Coatbridge), Limited, 15,499 preference shares, 48,714 ordinary shares, and £25,769 19s 10d in cash; William Tudhope & Son, Limited, 6,843 preference shares, 21,508 ordinary shares, and £11,325 4s 4d in cash; The Victoria Iron and Steel Company, Limited, 11,182 preference shares, 35,147 ordinary shares, and £15,849 18s 6d in cash; Waverley Iron and Steel Company, Limited, 30,071 preference shares, 34,698 ordinary shares, and £144,000 14s 8d in cash; Wylie & Company, 9,876 preference shares, 31,042 ordinary shares, and £12,999 16s 2d in cash; The Woodside Steel and Iron Company, Limited, 38,114 ordinary shares, and £36,223 3s 1d in cash.

Such fully-paid preference and ordinary shares are the whole of the shares issued or agreed to be issued as fully or partly paid up otherwise than in cash.

The minimum subscription upon which the directors may proceed to allotment is 150,000 preference shares.

The whole of the present issue has been guaranteed for a commission (which includes underwriting and over-riding commissions) payable by the company at the rate of 4 per cent in the case of the mortgage debenture stock, and of 6½ per cent in the case of the preference shares.

The preliminary expenses other than the above, including the expenses and stamp duties of the conveyances to the company, are estimated to amount to £25,000. These are payable by the company.

The following contracts have been entered into:

Here follow details of twenty-six contracts.

The following directors are respectively interested in the promotion of the company, and in the business and others to be acquired by the company, as follows, *vis.*: Colin Faulds MacLaren, as a partner of C. F. MacLaren and Company; William Downs, as a partner of Downs and Jardine; David John Garrett, as a shareholder of Waverley Iron and Steel Company, Limited; George Bowen Bennett, as a shareholder of the Woodside Steel and Iron Company, Limited; Robert Crichton, as a shareholder of the Victoria Iron and Steel Company, Limited; Thomas Ronald Miller as one of the trustees of the late Alexander Ronald Miller, iron manufacturer, Motherwell, who carry on business under the name of A. and P. Miller; John William Arthur Spencer, as a shareholder of John Spencer (Coatbridge), Limited; Robert Waterson, as a shareholder of Thomas Ellis, Limited; and William Wylie, as a partner of Wylie and Company.

The following directors are interested in the underwriting, having subunderwritten (at a commission at the rate of 2½ per cent in the case of the debenture stock and at a commission at the rate of 4 per cent in the case of the preference shares), debenture stock to the amount and preference shares to the number following their respective names, *vide licet*: C. F. MacLaren, 4,000 preference shares; William Downs, £1,300 debenture stock and 5,120 preference shares; David John Garrett, 2,500 preference shares; Thomas R. Miller, £4,700 debenture stock and 6,000 preference shares; J. W. Arthur Spencer, £3,000 debenture stock and 4,200 preference shares; Robert Waterson, 3,000 preference shares; and William Wylie, £600 debenture stock and 1,400 preference shares.

By the contracts above mentioned it is also provided that several of the directors should, along with other officials of the vendor companies and firms, receive engagements with the company on the terms therein specified.

Application will be made for a settlement and quotation for the de-

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debenture stock and the preference and ordinary shares of the company on the London, Glasgow, and Edinburgh Stock Exchanges.

Applications for debenture stock and preference shares must be made on one of the accompanying forms, and must be sent to the bankers of the company with a remittance for the amount payable on application.

If the amount of debenture stock or number of preference shares allotted to any applicant is less than the amount or number applied for by such applicant, the surplus will be credited in reduction of the amount payable on allotment, and the balance (if any) will be returned.

Failure to pay any instalment when due will render the allotment liable to cancellation and previous payments to forfeiture.

A brokerage of one-half per cent will be paid by the company to brokers and other approved agents upon all debenture stock and preference shares allotted on forms of application, other than underwriting applications, bearing their stamps.

Prospectuses and application forms may be obtained at the offices of the company, and from the British, Foreign, and Colonial Corporation, Limited, 57 Bishopsgate, London, E. C., and from the bankers, the brokers, and solicitors. Dated the 27th day of June, 1912.

THIS FORM MAY BE USED

This form should be sent with a deposit of 5 per cent to The London City and Midland Bank, Limited, Threadneedle Street, London, E. C., or branches; or to The British Linen Bank, Glasgow, Edinburgh, or branches; or to The Clydesdale Bank, Limited, Glasgow, Edinburgh, or branches.

No. A

FORM OF APPLICATION FOR DEBENTURE STOCK

THE SCOTTISH IRON & STEEL COMPANY, LIMITED

[Incorporated under the Companies (Consolidation) Act, 1908]

Issue of £300,000 Five Per Cent Redeemable First Mortgage
Debenture Stock at 95 Per Cent

To the Directors of The Scottish Iron and Steel Company, Limited:

Gentlemen—Having paid to the company's bankers the sum of £..... being a deposit of 5 per cent on application for £..... of the above mentioned five per cent redeemable first mortgage debenture stock, I (we) hereby request you to allot to me (us) that amount of debenture stock, and I (we) agree to accept the same or any less amount that may be allotted to me (us) upon the terms of the prospectus, dated the 27th day of June, 1912, and to pay the balance due as provided by the said prospectus.

Ordinary Signature
Name (in full)
Address
* Occupation or Description
Date, 1912

* If a lady, state whether "Mrs." or "Miss."

Please write distinctly

Cheques should be made payable to The London City and Midland Bank, Limited, The British Linen Bank, or The Clydesdale Bank, Limited.

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THIS FORM MAY BE USED

This form is to be filled up and forwarded with a deposit of 1s per share to the London City and Midland Bank (Limited), Threadneedle Street, London, E. C.; or branches; or to the British Linen Bank, Glasgow, Edinburgh, or any of its branches; or to the Clydesdale Bank (Limited), Glasgow, Edinburgh, or any of its branches.

No. A

FORM OF APPLICATION FOR PREFERENCE SHARES

THE SCOTTISH IRON & STEEL COMPANY, LIMITED

[Incorporated under the Companies (Consolidation) Act, 1908]

Issue of 150,000 Six Per Cent £1 Cumulative Participating
Preference Shares at Par

To the Directors of The Scottish Iron and Steel Company, Limited:

GENTLEMEN:

Having paid to your bankers the sum of £....., being a deposit of 1s per share on..... six per cent £1 cumulative participating preference shares of the Scottish Iron and Steel Company (Limited), I request that these shares may be allotted to me upon the terms of the prospectus, dated the 27th June, 1912, and memorandum and articles of association, and I agree to accept the same, or any less number that may be allotted me, and to pay the further instalments as provided in the said prospectus.

Ordinary Signature
Name (in full)
Address
Occupation
Date, 1912
If a lady, state whether "Mrs. or "Miss."

A Slander Refuted

It has been brought to the notice of the American Association of Public Accountants that representatives of one of the surety companies operating in the middle west have made the assertion that losses have been incurred by bonding companies through errors intentional or otherwise made by accountants. The statement did not aver that these were errors by public accountants but the obvious purport of the assertion was to that effect.

This is an exceedingly serious matter and if the statement is without foundation it should be most emphatically denied. No doubt surety companies have suffered many losses through the inefficiency or worse of accountants employed by corporations

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or firms and entrusted with handling of funds; but these things have no possible bearing upon public accountancy and it is to be hoped that the statements which have been mentioned will be traced to their source and vigorously challenged.

It is particularly important that this should be done because the profession of public accountancy prides itself with great justification upon its immunity from such delinquencies as losses of the kind described would indicate.

In order to make certain that there was no foundation for the allegations in question the American Association has consulted with all its constituent state societies. Replies have been received from officers of most of the societies and so far there has not been a single report of any such loss in any part of the country.

We deeply deplore the statements which have been made to the detriment of public accountants but it is eminently gratifying to find so unanimous a report from the various parts of the country repudiating the slander. On the principle that out of evil cometh good it may be that the utterance of a false accusation has been beneficial. We doubt if many other professions or vocations could present so clean a slate.

A Students' Department

Beginning with this number of *THE JOURNAL OF ACCOUNTANCY* we present to our readers a new department which we believe will be of value and interest to a large number of accountants. For some time *THE JOURNAL* has been hoping to secure the services of Mr. SEYMOUR WALTON, of Chicago, as editor of this proposed department and it is with a considerable amount of satisfaction that we are able to make a definite announcement of his acceptance of this post and that under his direction *THE JOURNAL* will institute a new department for students at the beginning of the new year.

The interest which is now taken in the education of accountants is far greater than at any prior time and it is indubitable that as accountancy progresses the importance of the training of students in accountancy will increase even more rapidly.

THE JOURNAL OF ACCOUNTANCY has always been a leader

of professional thought, and it is our desire that it shall contain not only matter of value to the more advanced practitioner but that it shall also provide something for those who are not yet in active service. Accountants as a rule are not given to excess of self-confidence because they realize that the work and scope of the profession is advancing so quickly that it is almost impossible to keep pace with it. Therefore, we believe that even the practising accountant will find much of interest and something of value in this new department under the charge of so well-known an authority as MR. WALTON.

In the opening article of the series the editor of the students' department explains clearly the idea which he wishes to pursue and we desire to direct special attention to the foreword which appears on another page of this magazine.

Government Ownership

The postal service constitutes the only large business operation in which the government is engaged. It is a cash business, involving an expenditure of over \$210,000,000 during the current year, and this stupendous expenditure is destined to grow with the growth of the country.

* * * * *

It appears too obvious to require argument that the most efficient service can never be expected as long as the direction of the business is, as at present intrusted to a postmaster-general and certain assistants selected without reference to experience and qualifications and subject to frequent change. Before the postmaster-general and his assistants can become reasonably familiar with the operations of the service they are replaced by others, who, in turn, are called upon to resign before they can, in the nature of things, become qualified by knowledge and experience to perform their allotted tasks. Under such a system a large railroad, commercial, or industrial business would inevitably go into bankruptcy, and the Post-Office Department has averted that fate only because the United States Treasury has been available to meet deficiencies.

The foregoing is not the irresponsible statement of a demagogue or a yellow journal but is taken from the *Preliminary Report of Joint Commission on Business Method of Post-Office Department and Postal Service* submitted to congress on February 10, 1908, by a commission composed of Senators Boies Penrose and Thomas H. Carter and Representatives A. S. Clay, Jesse Overstreet, J. J. Gardner and John A. Moon. This commission was appointed under an act of congress approved March 2, 1907, and spent several months, aided by two firms

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of accountants, in making a careful study of the business methods of the post-office department and the postal service of the United States.

The statement quoted above is at this time charged with special significance in view of the recommendations of the present postmaster-general relative to government ownership of telegraph and telephone properties. A study of the report above referred to is calculated to suggest to any intelligent man the futility of expecting governmental operation of business to attain a high order of efficiency and as this subject is not one of party politics so much as of common-sense and business judgment, *THE JOURNAL OF ACCOUNTANCY* may have occasion in future to refer to other parts of the report.

It is a mere truism, admitted by any one who has had an opportunity to observe, that the business of the government is often done either badly or very expensively and frequently both badly and expensively. Is it not, then, befitting for our government officials in Washington to think about putting their house in order so that the duties with which they are now charged may be performed in a reasonably satisfactory manner and to think rather less about extending their authority into fields where their failures might be even more pronounced than they are now?

We commend the report of the joint commission referred to above to the consideration of the postmaster-general and to the business men of the country who, after all, must in a large measure pay the piper.

Income Tax Department

EDITED BY JOHN B. NIVEN, C.P.A.

There are published this month further rulings which have been issued by the Treasury department. Stated briefly the tenor of these rulings is as follows:

Ruling No. 1910, December 4, 1913, is the first decision on an actual case laid before the Treasury department arising out of the income tax law. It is in the form of a letter addressed to the collector, sixth division, Los Angeles, and relates to the irrigation and reclamation districts of California. The department holds that these districts are not political subdivisions of the state nor public utilities exercising any essential governmental functions accruing to any state or territory within the meaning of the income tax law, and that therefore the interest or income from bonds or other obligations of such districts is not exempt from the tax.

Ruling No. 1911, December 8, 1913, prescribes a form of certificate which may be used by fiduciaries who do not wish to exercise the privilege of exemption from having the normal tax deducted at the source granted to them in a previous ruling.

Ruling No. 1912, December 8, 1913, extends the time in which forms Nos. 1000, 1001, 1003 and 1004 may be used to January 15, 1914.

Ruling No. 1914, December 9, 1913, gives forms for itemized monthly list returns and summarized annual list returns to be made by withholding agents of all coupon and registered interest payments on which the normal tax was withheld. No special form of return has yet been prescribed for certificates of ownership which accompany coupon or registered interest orders when the owners of the bonds are not subject to having tax withheld at the source, but under this ruling, all such certificates are to be forwarded monthly to the collector. The monthly list returns above provided for have to be made to the collector for the district on the twentieth day of each month for the preceding month and, it is stated, withholding agents may, if they so desire, pay at the same time the amount of tax withheld. It is presumed if the tax so withheld is not paid monthly, assessment will be made on the withholding agent for the amounts collected in the previous calendar year and payment will be required on June 30th. The summarized annual list returns have to be made to the collector on or before March 1st.

Ruling No. 1915, December 5th, 1913, is an extension of and supplementary to T. D. ruling No. 1903. It prescribes the forms to be used by collecting agents when they substitute their certificates in place of owners certificates Nos. 1001, 1003, 1004, 1011, 1014, 1015, 1016 and 1018.

Ruling No. 1916, December 5, 1913, states that foreign organizations engaged in business in the United States are exempt from having any part of their income withheld by a debtor or withholding agent and it

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prescribes the certificate to be furnished by foreign organizations to debtors and withholding agents.

Ruling 1917, December 16, 1913, extends the time for filing the itemized monthly list returns prescribed in ruling No. 1914 so far as they relate to the month of November, 1913, to January 5th, 1914.

In addition to the rulings before mentioned, which are printed in full in this month's issue of *THE JOURNAL OF ACCOUNTANCY* the Treasury department publishes, under ruling No. 1913, December 11, 1913, a decision of the United States supreme court in the case of *Stratton's Independence (Ltd.) v. F. W. Howbert, Collector of Internal Revenue in and for the district of Colorado*. The text of this ruling is not given as the action deals wholly with the provisions of the corporation tax act of 1909, but in effect the court holds that the corporation tax act, imposing a special excise tax on corporations, applies to mining companies; that the tax is not an income tax but imposes an excise tax upon the conduct of business in a corporate capacity, measuring the amount of tax by the income of the corporation; that the proceeds of ore mined by mining companies from their properties is income within the meaning of the corporation tax act; and that mining companies, in making returns of net income, are not allowed to deduct from gross income, on account of depreciation, the difference between the value of the product and the cost of production.

TREASURY RULINGS

(T. D. 1910 December 4, 1913)

Letter to Collector, Sixth District, Los Angeles, California

Irrigation and reclamation assessment districts are not political subdivisions of the State nor are they public utilities exercising any essential governmental functions accruing to any State or Territory, within the meaning of the Federal income-tax law. Interest or income from bonds or other obligations of such districts is not exempt from the income tax.

SIR: In reply to your letter dated November 14, 1913, with which was forwarded copies of the California State laws with respect to the irrigation and reclamation districts of California, and in which you set forth at length the status of such irrigation and reclamation districts, and in which the question is raised as to whether the interest derived from bonds issued under authority of this state to finance such irrigation and reclamation projects is subject to the income tax, you are informed as follows:

It appears that these irrigation and reclamation districts are created by special or general state laws which provide that their organization be

perfected upon petitions signed by the required number of holders of title, or evidence of title, to lands within such proposed districts, and when such districts are thus created, bonds to secure funds for the necessary improvements are issued and the interest charges thereon are met by taxes specifically levied upon the lands benefited by the improvements.

The vote necessary to secure the issue of bonds is confined to the owners of real property, and neither the franchises, benefits, nor burdens are extended to or imposed for the general welfare of all the people inhabiting such districts.

It would appear, therefore, that such districts are not created for the general welfare or as public utilities in the administration of government for the benefit of all the people.

The income-tax law provides "that in computing net income under this section, there shall be excluded the interest upon the obligations of a state or any political subdivision thereof." The law further provides:

There shall not be taxed under this section any income derived from any public utility or from the exercising of any essential governmental function accruing to any state, territory, or the district of Columbia, or any political subdivision of a state, territory, or the district of Columbia.

The law also provides that in computing the net income of a person, no deduction shall be allowed for taxes assessed against local benefits, nor for any amount paid out for betterments made to increase the value of any property or estate.

The question at issue, therefore, would appear to depend entirely upon whether the irrigation and reclamation districts under consideration are political subdivisions of a state or whether they are simply assessment districts in which the assessment is made against local benefits, and whether, in the case of the districts under consideration, such districts are not created solely for the purpose of local benefits and for the purpose of confining the expense of such benefits to the particular persons who are benefited thereby.

In the case of *Smith v. Howell*, (60 N. J. L., 384), it is held that—

A political division to whose boundaries a general tax may be confined is a division of the state with its inhabitants organized for the public advantage and not in the interest of particular individuals or classes, the chief design of which is the exercise of governmental functions, and to the electors residing within which is, to some extent, committed the power of local government.

In *State v. Englewood Drainage, etc., Commissioners*, (41 N. J. L., 154), it is held that such political subdivision—

Does not include a sewerage, drainage, and water district under a board to be elected every five years by male and female resident landowners in fee, such board being invested with some control over a defined territory, but having no concern with the inhabitants, such district being formed, not for public advantage, but in the interest of a particular class—the landowners—and the chief end of which is not the government of the persons and things within its territory, but mere land improvement at the

Income Tax Department

expense of the land either by general tax or special assessment, and the electors of which district have no voice whatever in its corporate affairs.

It would appear, therefore, that state laws providing for the taxation of certain districts created for a special purpose and for the special benefit of persons residing within, and owning real property within, certain prescribed limits does not create a subdivision of the state, nor are such laws intended to create a subdivision of the state, as that term is used in the income-tax law, but such districts are created under authority of the state simply to enable certain groups of citizens of the state to do that which they otherwise could not do without such legal sanction.

State agencies not existing for purely governmental purposes do not fall within any rule exempting the sovereign power of the state or any political subdivision thereof from Federal taxation.

It is, therefore, held that such irrigation and reclamation assessment districts are not political subdivisions of the state within the meaning of the income-tax law, nor are they public utilities exercising any essential governmental functions accruing to any state or territory, and that the interest or income from the bonds or other obligations of such districts is not exempt from the income tax.

(T. D. 1911 December 8, 1913)

Supplemental regulations prescribing form of certificate which may be used by fiduciaries, when said fiduciaries do not desire to claim any exemption from having the normal tax of 1 per cent withheld by the debtor organization at the source.

Fiduciary agents may, if they so desire, use instead of Form 1015 prescribed in supplemental regulations (T. D. 1906) of November 28, 1913, a certificate in substantially the following form:

(FORM 1019)

Form of certificate to be filed with debtor or withholding agents by fiduciaries when not claiming any exemption, as an alternative to the filing of Form No. 1015 in which exemption is claimed.

The following form of certificate may be filed with the debtor, or its paying agents, at the time of the payment to the fiduciary, or his representative, of all coupons, interest orders, rents, and all other kinds of income whatsoever upon which the tax on income is required to be withheld at the source, as an alternative to the filing of Form No. 1015:

I (we) do solemnly declare that I (we).....(Name fiduciary) am (are) the duly authorized.....(Indicate in what capacity acting) for the beneficiaries of the estate or trust of....., which estate or trust is entitled to the income from \$...... bonds of the denominations of \$...... each, Nos. of the

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.....(Give name of debtor) known as.....(Describe the particular issue of bonds) bonds, from which were detached the accompanying coupons, due....., 191..., amounting to \$....., or upon which there has matured....., 191..., \$..... of registered interest, or which estate or trust is entitled to other income from property or investments upon which there accrued....., 191..., \$..... of income.

Acting for and in the capacity herein stated, I hereby declare that I (we) do not now claim any exemption from having the normal tax of 1 per cent withheld from said income by the debtor at the source.

.....
(Name) (Capacity in which acting)
Date:, 191... (Address)

When the fiduciary uses the above form of certificate the debtor organization shall be the *source* for the deduction and withholding of the normal tax of 1 per cent, as required by regulations, and fiduciaries receiving the income described in the said certificate from which the 1 per cent normal tax has thus been withheld, shall not be required to again deduct and withhold the normal tax of 1 per cent upon the said income.

(T. D. 1912 December 8, 1913)

Extension of time to January 15, 1914, for use of Forms 1000 (original and amended), 1001, 1003, and 1004, as provided in T. D. 1907 of November 26, 1913.

The time in which Forms 1000 (original and amended), 1001, 1003, and 1004, as provided in T. D. 1907, issued November 26, 1913, may be used shall be extended to January 15, 1914.

(T. D. 1914 December 9, 1913)

Supplemental regulations prescribing how itemized monthly list returns and annual list returns of all coupon and registered interest payments on which the normal tax of 1 per cent was withheld shall be made, pursuant to regulations for the administration of section 2 of the act of October 3, 1913.

Debtors or withholding agents are required by regulations made in pursuance to section 2, act of October 3, 1913, to make both a monthly and an annual list return.

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The required monthly list return shall give a list of all coupon or interest payments made, on which the normal tax of 1 per cent was deducted and withheld and shall show the name and address in full of the owners of the bonds, amount of the income, amount of exemption claimed, amount of income on which withholding agent is liable for tax, and the amount of tax withheld, and shall be made in substantially the following form:

(FORM 1012)

Monthly list return of amount of income tax withheld at the source

Filed by (Name of debtor organization)

To be made in duplicate to the collector of internal revenue for the district in which the withholding agent is located on or before the 20th day of each month, showing the names and addresses of persons who have received payments of interest upon bonds and mortgages or deeds of trust, or other similar obligations of corporations, joint-stock companies, or associations, and insurance companies, on which the normal tax of 1 per cent has been deducted and withheld during the preceding month.

I (we) (Name) of (State address in full), the duly authorized withholding agent of (State name of debtor organization) located at (Address in full), do solemnly swear (or affirm) that the following is a true and complete return of all coupon and interest payments as above described, made by said organization and from which the normal tax of 1 per cent was deducted and withheld, at the time of payment or for which it is liable as withholding agent, during the month of, 191..., on the (Describe the particular issue of bonds) bonds (or other obligations) of the (Name of debtor organization), and there are herewith inclosed all certificates of ownership which were presented with said coupons or orders for registered interest covering the interest maturing on \$..... of the bonds described.

| Name. | Address in full. | Amount of income | Amount of exemption claimed. | Amount of income on which withholding agent is liable for tax. | Amount of tax withheld. |
|--|------------------|------------------|------------------------------|--|-------------------------|
| | | \$..... | \$..... | \$..... | \$..... |
| | | | | | |
| | | | | | |
| | | | | | |
| Total for months..... | | | | | |
| Amount of tax remitted herewith (if any) to collector..... | | | | | |

To..... Sworn to and subscribed Signed:
 Collector. before me this
District of..... day of.....191.....

 (Address) (Capacity in which acting)

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NOTE A—Withholding agents may, if they so desire, pay at the time this list is filed, to the collector of internal revenue with whom the list is filed, the amount of tax withheld during the month for which the list is made.

NOTE B—All substitute certificates of collecting agents, authorized by regulations, that are received by debtors or withholding agents will be considered the same as certificates of owners, and in entering same in making monthly list returns, debtors or withholding agents will enter the name, address, and the number of the substitute certificates of the collecting agent in lieu of the name and address of the owner of the bonds.

Form 1012A. Includes all heading Form 1012, but omits bottom.

Form 1012B. With box heading Form 1012, omits head and tail.

Form 1012C. Omits heading Form 1012, includes tail.

Form 1012D, when necessary to be used, shall be a summary of the monthly list return, Form 1012, as made in detail by the withholding agent and the said summary and lists thereto attached when properly filled in and the summary signed and sworn to shall constitute the complete monthly list return of the withholding agent making same, as fully as if each list attached to the summary was signed and sworn to separately.

The said Form 1012D shall be in substantially the following form:

(FORM 1012)

Summary of monthly list return of amount of normal income tax withheld at the source

Filed by(Name of debtor organization)

To be made in duplicate to the Collector of Internal Revenue for the district in which the withholding agent is located, on or before the 20th day of each month, showing the names and addresses of persons who have received payments of interest upon bonds and mortgages, or deeds of trust, or other similar obligations of corporations, joint stock companies, or associations, and insurance companies, on which the normal tax of 1 per cent has been deducted and withheld during the preceding month.

I (we).....(Name) of.....(State address in full), the duly authorized withholding agent of.....(State name of debtor organization), located at.....(Address in full), do solemnly swear (or affirm) that the following is a true and complete return of all coupon and interest payments as above described made by said organization and from which the normal tax of 1 per cent was deducted and withheld, at the time of payment, or for which it is liable as withholding agent, during the month of.....(date), 191..., on bonds (or other similar obligations) of the.....(Name of debtor organization), as fully set forth in detail, on lists attached hereto, said lists, Form 1012, and this summary, constituting the *Monthly List Return of Normal Income Tax Withheld at the Source* as required by the regulations; and that there are herewith inclosed all certificates of ownership which were presented with said coupons or orders for registered interest covering the interest maturing on \$..... of the bonds described, and that said withholding agent has paid no coupons or orders for registered interest not accompanied by the certificates of ownership as required by Treasury regulations.

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| Description of obligation. | Amount of income. | Amount of exemption claimed. | Amount of income on which withholding agent is liable for tax. | Amount of tax withheld. |
|----------------------------|-------------------|------------------------------|--|-------------------------|
| | \$ | \$ | \$ | \$ |
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To....., Sworn to and subscribed Signed:
Collector. before me this
..... District of..... day of..... 191.....
.....
(Address) (Capacity in which acting)

NOTE A—Withholding agents may, if they so desire, pay at the time this list is filed, to the Collector of Internal Revenue with whom the list is filed, the amount of tax withheld during the month for which the list is made.

NOTE B—All substitute certificates of collecting agents, authorized by regulations, that are received by debtors or withholding agents will be considered the same as certificates of owners, and in entering same in making Monthly List Returns, debtors or withholding agents will enter the name, address, and the number of the substitute certificate of the collecting agent in lieu of the name and address of the owner of the bonds.

The annual list return to be made by debtors or withholding agents of the normal tax of 1 per cent withheld from interest payments made upon bonds or other similar obligations shall be made on or before March 1 of each calendar year and in substantially the following form:

(FORM 1013)

Annual list return of amount of normal income tax withheld at the source from interest upon bonds and mortgages or deeds of trust or other similar obligations of corporations, joint-stock companies or associations, and insurance companies.

Filed by (Name of debtor organization)

To be made in duplicate to the collector of internal revenue for the district in which the withholding agent is located on or before March 1, showing the totals of each monthly return on Form 1012, and their aggregate totals for the preceding calendar year.

I (we).....(Name) of.....(State address in full), the duly authorized withholding agent of.....(State name of debtor organization), located at.....(State address in full), do solemnly swear (or affirm) that the following is a true and complete return of the monthly totals of all coupon and interest payments made and normal taxes withheld therefrom by said organization or for which it is liable as withholding agent as reported on Form 1012, and their aggregate totals for the year ended December 31, 191....

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| Month. | Amount of income. | Amount of exemption claimed. | Amount of income on which withholding agent is liable for tax. | Amount of tax withheld. | Amount of tax remitted to collector. | Balance of tax due. |
|---------------------------|-------------------|------------------------------|--|-------------------------|--------------------------------------|---------------------|
| January | \$ | \$ | \$ | \$ | \$ | \$ |
| February | | | | | | |
| March | | | | | | |
| April | | | | | | |
| May | | | | | | |
| June | | | | | | |
| July | | | | | | |
| August | | | | | | |
| September | | | | | | |
| October | | | | | | |
| November | | | | | | |
| December | | | | | | |
| Aggregate Totals for year | | | | | | |

To....., Sworn to and subscribed Signed:
 Collector. before me this
 District of..... day of..... 191.....
 (Address) (Capacity in which acting)

The monthly list return in the form as required herein shall constitute a part of the annual list return to be made by debtors or withholding agents, and the debtor or withholding agent will not be required in making an annual list return of the tax withheld from income derived from interest upon bonds and mortgages or deeds of trust, or other similar obligations of corporations, joint stock companies, or associations and insurance companies, to again make an itemized list of the amount of tax withheld from each person, but will give in the annual list return the totals of the monthly list return for each month of the year for which annual list return is made.

All substitute certificates of collecting agents authorized by regulations that are received by debtors or withholding agents will be considered the same as certificates of owners, and in entering same in making monthly list returns, debtors or withholding agents will enter the name and address of the collecting agent and the number of the substitute certificate issued in lieu of the original certificate containing the name and address of the owner of the bonds.

Until the further ruling on this subject by this department no list return is required to be made of certificates of ownership accompanying the coupons or registered interest orders filed with a debtor or withholding agent, *when the owners of the bonds are not subject to having the normal tax withheld at the source*, but all such certificates of ownership shall be forwarded by the debtor or withholding agent to the collector of internal revenue for his or its district, on or before the 20th day of the month succeeding that in which said certificates of ownership were received by him or it.

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All forms of monthly and annual list returns herein provided for shall be 10½ inches wide and 16 inches from top to bottom.

(T. D. 1915 December 5, 1913)

Supplemental regulations prescribing forms of certificates to be attached to interest coupons in cases where the collecting agent's certificate is substituted for the certificate of the owners.

Subject to the provisions of the regulations in T. D. 1903, dated November 28, 1913, collecting agents may substitute Form 1000a, properly filled in and numbered, for the certificate of the owner on Form 1000.

When collecting agents substitute their own certificate in lieu of owner's certificate on Form 1001, said substitute certificate shall be in substantially the following form:

(FORM 1001a)

Form of certificate to be attached to interest coupons in cases where the collecting agent's certificate is substituted for the certificate of the owners.

(When owner is a domestic organization not subject to taxes on income at source)

(The owner's certificate, of which the following certificate is the counterpart, and bears the same number as this certificate, will be sent by the collecting agent direct to the Commissioner of Internal Revenue, at Washington, as prescribed by regulations.)

No.....

I (we).....(Name of collecting agent) do solemnly declare that the owner of \$...... bonds of the.....(Name of debtor organization), from which were detached the accompanying interest coupons due(Maturity), 191..., amounting to \$....., has filed with me (us) a duly executed certificate filled up in accordance with Treasury Regulations of October 25, 1913, Form No. 1001, which certificate has been indorsed by me (us) as follows: "Owner's certificate No.....(Name of collecting agency),, 191...", and that under the provisions of the income-tax law of October 3, 1913, said interest is exempt from the payment of taxes collectible at the source, which exemption is hereby claimed, and I (we) do hereby promise and pledge { myself } { ourselves } to forward the above-described certificate executed by the owners as stated and dated....., 191..., to the Commissioner of Internal Revenue, at Washington, D. C., not later than the 20th day of next month, in accordance with Treasury Regulations.

Signature of collecting agent,.....

Address,.....

Date,, 191....

When collecting agents substitute their own certificate in lieu of owner's certificate on Form 1003, said substitute certificate shall be in substantially the following form:

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(FORM 1003a)

Form of certificate to be attached to interest coupons in cases where the collecting agent's certificate is substituted for the certificate of the owners.

(When said owners are firms or copartnerships in the United States)

(The owner's certificate, of which the following certificate is the counterpart, and bears the same number as this certificate, will be sent by the collecting agent direct to the Commissioner of Internal Revenue, at Washington, as prescribed by regulations.)

No.

I (we).....(Name of collecting agent) do solemnly declare that the owner of \$....., bonds of the.....(Name of debtor organization), from which were detached the accompanying interest coupons due(Maturity), 191..., amounting to \$....., has filed with me (us) a duly executed certificate filled up in accordance with Treasury Regulations of October 25, 1913, Form No. 1003, which certificate has been indorsed by me (us) as follows: "Owner's certificate No.....,(Name of collecting agency),(Date), 191....," and that the name and address of the firm or partnership, and the names of the individual members thereof, and their places of residence were recorded on said original certificate, and I (we) do hereby promise and pledge { myself } to forward the above-described certificate executed by the owners as stated and dated....., 191..., to the Commissioner of Internal Revenue, at Washington, D. C., not later than the 20th day of next month, in accordance with Treasury Regulations.

Signature of collecting agent,.....

Address,.....

Date,, 191....

When collecting agents substitute their own certificates in lieu of owner's certificate on Form 1004, said substitute certificate shall be in substantially the following form:

(FORM 1004a)

Form of certificate to be attached to interest coupons in cases where the collecting agent's certificate is substituted for the certificate of the owners.

(When owners are both citizens or subjects and residents of foreign countries)

(The owner's certificate, of which the following certificate is the counterpart, and bears the same number as this certificate, will be sent by the collecting agent direct to the Commissioner of Internal Revenue, at Washington, as prescribed by regulations.)

No.

I (we).....(Name of collecting agent) do solemnly declare that the owner of \$..... bonds of the.....(Name of debtor organization), from which were detached the accompanying interest coupons due(Maturity), 191..., amounting to \$....., has filed with me (us) a duly executed certificate filled up in accordance with Treasury Regulations of October 25, 1913, Form No. 1004, which certificate has been indorsed by me (us) as follows: "Owner's certificate No.....,(Name of collecting agency),(Date), 191....," and that the owner in said certificate declares that, being nonresident foreigner,

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said interest is exempt from the income tax imposed on such interest by the United States Government under the law enacted October 3, 1913, and that no citizen of the United States, wherever residing, or foreigner residing in the United States, or any of its possessions, has any interest in said bonds, coupons, or interest; and I (we) do hereby promise and pledge { myself
 { ourselves } to forward the above-described certificate executed by the owners as stated and dated....., 191..., to the Commissioner of Internal Revenue, at Washington, D. C., not later than the 20th day of next month, in accordance with Treasury Regulations.

Signature of collecting agent.....

Address.....

Date,, 191....

When collecting agents substitute their own certificate in lieu of owner's certificate on Form 1011, said substitute certificate shall be in substantially the following form:

(FORM 1011a)

Form of certificate to be attached to interest coupons in cases where the collecting agent's certificate is substituted for the certificate of the owners.

(When owner's are firms or copartnerships in the United States claiming deduction for tax on account of operating expenses incurred)

(The owner's certificate, of which the following certificate is the counterpart, and bears the same number as this certificate, will be sent by the collecting agent direct to the Commissioner of Internal Revenue, at Washington, as prescribed by regulations.)

No.

I (we).....(Name of collecting agent) do solemnly declare that the owner of \$..... bonds of the.....(Name of debtor organization) from which were detached the accompanying interest coupons due.....(Maturity), 191..., amounting to \$....., has filed with me (us) a duly executed certificate filled up in accordance with Treasury Regulations of November 28, 1913, Form No. 1011, which certificate has been indorsed by me (us) as follows: "Owner's certificate No.....,(Name of collecting agency),(Date), 191..., and the partnership in said certificate did claim a deduction of \$..... allowed on account of the actual expenses incurred in conducting said business, under regulations made in pursuance of section 2, act of October 3, 1913, and did solemnly declare that neither the partnership nor its individual members has claimed deductions in excess of its total actual legitimate annual expenses of conducting the business of said partnership, and that no portion of the living or personal expenses of the partners is included in the deductions claimed, and I (we) do hereby promise and pledge { myself
 { ourselves } to forward the above-described certificate executed by the owners as stated and dated....., 191..., to the Commissioner of Internal Revenue, at Washington, D. C., not later than the 20th day of next month, in accordance with Treasury Regulations.

Signature of collecting agent.....

Address.....

Date,, 191....

When collecting agents substitute their own certificate in lieu of

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owner's certificate on Form 1014, said substitute certificate shall be in substantially the following form:

(FORM 1014a)

Form of certificate to be attached to interest coupons in cases where the collecting agent's certificate is substituted for the certificate of the owners.

(When owners are firms or copartnerships of foreign countries and claim immunity from income tax)

(The owner's certificate, of which the following certificate is the counterpart, and bears the same number as this certificate, will be sent by the collecting agent direct to the Commissioner of Internal Revenue, at Washington, as prescribed by regulations.)

No.....

I (we).....(Name of collecting agent), do solemnly declare that the owner of \$...... bonds of the.....(Name of debtor organization), from which were detached the accompanying interest coupons due(Maturity), 191..., amounting to \$......, has filed with me (us) a duly executed certificate filled up in accordance with Treasury Regulations of November 28, 1913, Form No. 1014, which certificate has been indorsed by me (us) as follows: "Owner's certificate No.....,(Name of collecting agency),(Date), 191....," and that said certificates declare that said owners are a copartnership and that all the members of the firm or partnership, except partners whose names are recorded thereon, are nonresident foreigners and as such are exempt from the income tax imposed on such income by the United States Government under the law enacted October 3, 1913, and that no citizen of the United States, wherever residing, or foreigner residing in the United States or any of its possessions, except those named above, has any interest in said bonds, coupons, or interest; and I (we) do hereby promise and pledge { myself } to forward the above-described certificate executed by the owners as stated and dated....., 191..., to the Commissioner of Internal Revenue, at Washington, D. C., not later than the 20th day of next month, in accordance with Treasury Regulations.

Signature of collecting agent,.....
Address,.....

Date,, 191....

When collecting agents substitute their own certificate in lieu of owner's certificate on Form 1015, said substitute certificate shall be in substantially the following form:

(FORM 1015a)

Form of certificate to be attached to interest coupons in cases where the collecting agent's certificate is substituted for the certificate of the owners.

(When owners are fiduciaries)

(The owner's certificate, of which the following certificate is the counterpart, and bears the same number as this certificate, will be sent by the collecting agent direct to the Commissioner of Internal Revenue, at Washington, as prescribed by regulations.)

Income Tax Department

No.....

I (we).....(Name of collecting agent), do solemnly declare that the owner of \$...... bonds of the.....(Name of debtor organization), from which were detached the accompanying interest coupons due(Maturity), 191..., amounting to \$......, has filed with me (us) a duly executed certificate filled up in accordance with Treasury Regulations of November 28, 1913, Form No. 1015, which certificate has been indorsed by me (us) as follows: "Owner's certificate No.....,(Name of collecting agency),(Date), 191..., " that said certificate is executed by a fiduciary, and that the fiduciary, acting for and in the capacity as stated therein, has assumed the duty and responsibility imposed upon withholding agents under the law, of withholding and paying the income tax due, for which he (it) may be liable, and that, acting in said fiduciary capacity as stated therein, he (it) did claim exemption from having the normal tax withheld from said income; and I (we) do hereby promise and pledge myself (ourselves) to forward the above-described certificate executed by the owners as stated and dated....., 191..., to the Commissioner of Internal Revenue, at Washington, D. C., not later than the 20th day of next month, in accordance with Treasury Regulations.

Signature of collecting agent,.....

Address,.....

Date,, 191....

When collecting agents substitute their own certificate in lieu of owner's certificate on Form 1016, said substitute certificate shall be in substantially the following form:

(FORM 1016a)

Form of certificate to be attached to interest coupons in cases where the collecting agent's certificate is substituted for the certificate of the owners.

(Owners being foreign organisation, not subject to the income tax at the source)

(The owner's certificate, of which the following certificate is the counterpart, and bears the same number as this certificate, will be sent by the collecting agent direct to the Commissioner of Internal Revenue, at Washington, as prescribed by regulations.)

No.....

I (we).....(Name of collecting agent) do solemnly declare that the owner of \$...... bonds of the.....(Name of debtor organization), from which were detached the accompanying interest coupons due(Maturity), 191..., amounting to \$......, has filed with me (us) a duly executed certificate filled up in accordance with Treasury Regulations of November 28, 1913, Form No. 1016, which certificate has been indorsed by me (us) as follows: "Owner's certificate No.....,(Name of collecting agency),(Date), 191," and that under the provisions of the income-tax law of October 3, 1913, the said organization in said certificate declares that it is a foreign organization, and that the said interest or income is exempt from the payment of taxes collectible at the source, which exemption it claims, and I (we) do hereby promise and pledge { myself } { ourselves } to forward the above-described certificate executed by the owners as stated and dated....., 191..., to the Commissioner of Internal Revenue, at Washington, D. C., not

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later than the 20th day of next month, in accordance with Treasury Regulations.

Signature of collecting agent,.....
Address,.....

Date,, 191....

When collecting agents substitute their own certificate in lieu of owner's certificate on Form 1018, said substitute certificate shall be in substantially the following form:

(FORM 1018a)

Form of certificate to be attached to interest coupons in cases where the collecting agent's certificate is substituted for the certificate of the owners.

(Owners being foreign organizations engaged in business in the United States and subject to tax)

(The owner's certificate, of which the following certificate is the counterpart, and bears the same number as this certificate, will be sent by the collecting agent direct to the Commissioner of Internal Revenue, at Washington, as prescribed by regulations.)

No.....

I (we).....(Name of collecting agent) do solemnly declare that the owner of \$..... bonds of the.....(Name of debtor organization), from which were detached the accompanying interest coupons due(Maturity), 191..., amounting to \$....., has filed with me (us) a duly executed certificate filled up in accordance with Treasury Regulations of December 5, 1913, Form No. 1018, which certificate has been indorsed by me (us) as follows: "Owner's certificate No.....,(Name of collecting agency),(Date), 191....," and that under the regulations made in pursuance of section 2, act of October 3, 1913, said organization is subject to the normal tax of 1 per centum per annum upon the amount of net income accruing from business transacted and capital invested with the United States and did therein claim exemption from having the said tax withheld at the source from said income, and I (we) do hereby promise and pledge myself (ourselves) to forward the above-described certificate executed by the owners as stated and dated....., 191..., to the Commissioner of Internal Revenue at Washington, D. C., not later than the 20th day of next month, in accordance with Treasury Regulations.

Signature of collecting agent,.....
Address,.....

Date,, 191....

All of the forms prescribed herein to be used by collecting agents for substitution in lieu of the owner's certificate, accompanying coupons to be presented for collection, shall be subject to all of the provisions of the regulations as published in T. D. 1903 of November 28, 1913, the same as the said regulations are made to apply to Form 1000a, as given therein.

(T. D. 1916 December 5, 1913)

Regulations prescribing form of certificate to be furnished by foreign organizations engaged in business in the United States and subject to the income tax on interest or other income collectible at the source.

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Foreign organizations engaged in business within the United States are subject to the normal tax of 1 per cent per annum upon the amount of net income accruing from business transacted and capital invested within the United States; but said organizations shall be exempt from having any part of their income withheld by a debtor or withholding agent.

The certificate to be furnished by foreign organizations engaged in business in the United States shall be in substantially the following form:

(FORM 1018)

Certificate to be furnished by foreign organizations engaged in business in the United States

I, (Give name), the (Give official position) (Name of organizations), a (Character of organization), of (County), located at (Post-Office address), do solemnly declare that said (Give name of organization) is a foreign organization engaged in business in the United States, and is the owner of \$ bonds, of the denomination of \$ each, Nos. of the (Give name of debtor), known as (Describe particular issue of bands) bonds, from which were detached the accompanying coupons, due 191..., amounting to \$, or upon which there matured 191..., \$ of registered interest, or is the owner of (Property or investments), upon which there was accrued 191..., \$ of income.

Under the provisions of the income-tax law of October 3, 1913, the said organization is subject to the normal tax of 1 per cent per annum upon the amount of net income accruing from business transacted and capital invested within the United States, for which tax it will make its return in due course, but it hereby claims exemption from having the said normal tax of 1 per cent on said income withheld at the source.

Name
..... (Official position)

Date 191... Of
Address (Name of organization)
 (Post office)

(T. D. 1917 December 16, 1913)

Extension of time for filing monthly list returns of all coupons and registered interest payments on which the normal tax of 1 per cent was withheld at the source in accordance with the requirements of section 2, act of October 3, 1913.

The time for filing itemized monthly list returns of coupon and registered interest payments for the month of November, 1913, which are required by regulations to be filed on or before December 20, 1913, is extended to January 5, 1914.

Students' Department

EDITED BY SEYMOUR WALTON, C.P.A.

FOREWORD

A few words of explanation are in order in regard to the objects to be aimed at in the studies which are to be pursued in this department. The consideration of these objects will include necessarily the discussion of what constitutes true education and what are the best means of obtaining it; what mental faculties it is necessary to cultivate, and how this can best be done; and to what extent mental training is valuable, whether that training is directly in the line of any person's daily work, or is only general in its character, conducing to habits of thought which will be valuable to any one who is ever confronted with problems of any kind, whose correct solution requires close and accurate reasoning.

It is not intended to lay out a connected course of business instruction such as is already given by many excellent schools of commerce and accounting in our larger cities. The intention is rather to supplement the work of these institutions by the discussion of subjects and the exposition of principles, as brought out in the solution of problems given in C. P. A. examinations. It may well be that the views expressed may not meet the approval of instructors in the established institutions, or of individual accountants throughout the country. If so, the columns of this department will always be open to the objectors, and their criticisms will be more than welcome. If the department does nothing more than to arouse among the accountants a discussion of mooted questions, it will have rendered a worthy service, since the great difficulty that has always handicapped *THE JOURNAL OF ACCOUNTANCY* has been that of inducing practical accountants to express themselves in print with regard to the many important subjects with which they are constantly required to deal.

The members of the various C. P. A. examining boards throughout this country and the Dominion of Canada can render an important service to the profession and to those who are working hard to enter it, if they will freely criticize the manner in which solutions to problems are given, whether in regard to the "general intelligence with which the questions are answered" or the technical way in which statements are set up. If there is too much of a tendency to "cut corners" so as to save time, let them so state, or if in their opinion there is not sufficient explanation of the principles involved to indicate the "general intelligence" asked for in the instructions on the examination papers, let them speak their minds, and criticize the inadequacy of the answers. A great point will be gained if the applicants for the degree can get a clear idea of what is required of them.

As the freest and fullest criticism is invited from the examiners, we trust that they will not take it amiss if we, in our turn, take occasion to

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offer them an occasional suggestion as to the wording of their problems and questions. Considerable time is often wasted by the candidates in trying to find out just what the examiners mean by some expression that a little change in the wording would have made perfectly plain. It is a little difficult for instance, to see why partners should take the trouble to make an agreement *inter se*, when they could just as well have made the agreement "among themselves," and not have left the applicant in doubt as to what important principle was indicated by the unfamiliar Latin words.

There is an old English engraving depicting a dying wife making a last request of her husband, who does not seem to be giving a very ready response, for she is represented as saying:

"Thou wilt, I know thou wilt. Sad silence gives consent,

And in this pleasing hope thy Emma dies content."

We trust that the examiners and other accountants will not force us to infer from their silence, sad or otherwise, that our ideas meet with their approval. Active criticism is better than that kind of negative endorsement. "In a multitude of counsellors there is wisdom," and it is only by the clash of minds that valuable truths can be brought out and firmly established.

TRUE EDUCATION

In order to fit oneself to become a practical accountant, either as a public practitioner or as the head of the accounting department of any large corporation, it is necessary to obtain a training which must consist of an extremely varied experience in accounting work or of an academic course of a high order, or better still, of both combined. Academic education alone will not make a finished accountant, and the wrong kind of education will do little towards accomplishing it, that is, the education that does no more than teach rules and facts without reaching any of the underlying principles. The only education that is of any real value is that which teaches the student to think clearly and to grasp the reason for any line of action, to know the "why" and not be satisfied simply with the "how." It will be found that the knowledge of the scientific why will greatly facilitate the carrying out of the more mechanical how.

DR. HENRY VAN DYKE clearly expressed this idea when he said: "The chief benefit that a good student may get in a good college is not a definite amount of Greek and Latin, mathematics and chemistry, botany and zoology, history and logic, though this in itself is good. But far better is the power to apprehend and distinguish, to weigh evidence and interpret facts, to think clearly, to infer carefully and to imagine vividly."

In these papers the constant endeavor will be to lead the student to carry out DR. VAN DYKE's ideas, by an exposition of principles, rather than a dogmatic statement of rules and of accounting methods, without the attempt to explain the reasons for their adoption.

It is true that the intelligent man, be he office man or mechanic, can

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pick up these principles from his own experience, and it is equally true that very large numbers do so, but it is necessarily at the expense of a large number of mistakes and even of positive failures. Experience is a good school, but unguided it is a dear one. Experience that is enlightened by a through knowledge of principles is the best school of all, and is in fact the only one that will produce any really practical results.

The man without theoretical knowledge is like a man in a strange country without a map or a compass. He knows where he wishes to go, but he has no idea in which direction to travel, nor which road to take. If he is given time enough to try one road after another, he will eventually hit upon the right one and reach his destination. Another man, with a good road map, made by those who have traversed the same ground before, will go straight to his desired haven, and lose no time in futile exploration. So a practical business man, guided by a good working theory, made by those who have previously investigated the subject, can go directly to the heart of any new situation, without wasting time in vain experiments. However, it must be remembered that, as the mere possession of the map will not carry the traveler to his destination, without intelligent action on his part, so the mere learning of a theory will not solve the business man's problems. He must know how to give it practical application, and this knowledge can come only through practical experience.

ADVANTAGES OF AN ACCOUNTING EDUCATION

One of the mistaken ideas in regard to an education in accountancy is that it is of value only to those who wish to become certified public accountants. While such persons must of necessity obtain this education in order to enable them to pass the very severe examinations which are to test their fitness to enter the profession, it does not follow that no others should endeavor to gain the knowledge that a proper study of accounting principles will give them.

The demand made by the business world today is for efficient men. The large corporations are constantly seeking for men who will be able to give them correct information in regard to all the intricacies of their business, information that will enable them to stop leaks and to institute economies in production and in selling, and that will show them exactly what are the results of each department, not merely what the final round-up of the whole business for a year may demonstrate. They cannot afford to have mistakes made in the methods by which the results are obtained, in the taking of inventories, in the calculation of averages of different years as to cost of production or of selling, and in many other things which it is vital to them to know. These mistakes can be avoided or if made, can be pointed out, only by one who has a thorough knowledge of accounting principles, whether he be a certified public accountant or not.

The difference between a certified public accountant and the equally competent man who has not obtained his certificate is very similar to the

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difference between solid silver ware made before it was customary to mark solid silver as "sterling" and that made since the hall-mark was used. The old ware is just as solid as the new, but there is nothing to show it. To prove that it is solid it must be tested, while a glance at the new will show whether it is or not. The certified public accountant possesses the hall-mark, which carries with it at least the presumption of ability. The other man must be tried. The burden of proof is on him, but it is not on the certified public accountant. For that reason the larger business concerns of the country are constantly offering inducements in the shape of very large salaries to certified public accountants, with whom they have become acquainted during the progress of an audit.

The possession of a certificate authorizing a person to write C. P. A. after his name is not an absolute proof of supreme excellence, but the ability to pass the rigid examination presupposes such a knowledge of accounting principles as to place the person in the enviable position of having good positions seek him, instead of being forced himself to seek the positions. He is, at least, given abundant opportunities to demonstrate whatever ability he may possess.

Therefore, while it is not necessary for a person who has taken the trouble to acquire an accounting education to pass the examination, it would be much better for him to do so. The education itself will be just as valuable an investment in either case.

ACCOUNTING PROBLEMS

It is not unusual for a student in an accounting class to neglect the task of solving the problems, giving one excuse or another, sometimes valid, but more often an evidence of mere lack of energy. Such a person will say that he is content with listening to the discussions in class, or with reading the text. This arises largely from the impression that the problems are merely exercises in mental gymnastics, or that they describe conditions that are not likely to be met with in ordinary experience. Even if this were true, the ability to grasp the fundamental principles involved in these problems, and to apply the proper methods in treating them will be invaluable when similar conditions are encountered in actual business life. The actual problems may not be the same as the theoretical ones, but the habits of thought developed in the study of the theoretical will be of enormous value in solving the business problems that are likely to arise in actual practice. There will be acquired an insight into conditions that will enable one to distinguish between superficial resemblances and real relations, which is one of the principal foundations of the scientific study of any subject.

A very important thing to be learned from the solving of accounting problems is the ability to read the problem correctly. Very frequently what looks like a purely perfunctory remark may involve an important point, if its true bearing on the conditions is properly appreciated. On the other hand an apparently important point may prove to have little

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or no influence in the final results. The ability really to grasp what is read may be cultivated, just as well as can the ability to observe what one sees. The difficulty that many people experience in remembering what cards have been played in a game of whist does not arise so much from a faulty memory as from lack of observation of the cards as they fell. The same woman who cannot remember the cards at all, will be able to describe minutely the costume of another woman of whom she had but a glimpse as she passed her in the hall. In one case she has a trained habit of observation; in the other she has not. In a treatise on memory it was recommended that a person should train himself to remember the articles seen in a shop window, when passing it at an ordinary walk. It was said that the power to remember would be wonderfully increased by such a practice. The truth is that it would be rather the power really to see the articles that would be cultivated.

ANALYSIS AND IMAGINATION

In order to arrive at the underlying principles in any problem, whether one asked in a C. P. A. examination or one encountered in actual practice, the possession of two mental faculties is essential—the analytical faculty and the imagination.

The analytical faculty enables one to grasp all the elements of a problem and to make an analysis of their real nature in their relations to each other, distinguishing between a superficial resemblance and an essential interdependence.

The right use of the imagination enables one to keep in mind an image or picture of the whole field to be covered, so that no one part will be overlooked while the attention is concentrated on some other part. This is especially important to the person who is devising a complete system of office or of factory cost accounts so that each point will be covered with due reference to every other point and that all of the several units will so dovetail into each other that the result will constitute a consistent and harmonious whole.

Both the faculties of analysis and imagination come into play in the study of the questions asked in C. P. A. examinations. Before an attempt is made to answer them, they should be thoroughly scrutinized, so that every element may be understood and completely covered in the answer, each element being duly considered in its relation to all the others.

The necessity for going clear to the bottom of a subject, so that it is certain that everything has been taken into full consideration, and that all the information that can be obtained from the problem has been given its due weight, is illustrated by the following problem. In an answer that was published in a magazine that has a department of C. P. A. problems, a solution was given in which it was stated that the problem contained no information as to whether or not the preferred stock was preferred as to assets as well as to dividends. A correct analysis of the conditions called for will determine this question without a shadow of a

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doubt. The reader will do well to study the problem, to see whether he can discover from the problem itself what is the status of the preferred stock, before he looks at the solution. In the published answer referred to the wrong view of the question was taken.

PROBLEM

The Chimera Chemical Company, a corporation engaged in the manufacture of patent medicines and toilet preparations, being unable to pay or renew its maturing obligations, Mr. Willoughby West, president of the company and owner of eighty per cent of its common stock, approaches the managers of the Opulent Oxygen Company with a proposition to sell out or consolidate. Mr. West submits a balance sheet, which purports to show his company's condition, as follows:

ASSETS

| | |
|-----------------------------------|----------------------------|
| Cash | \$ 1,007.21 |
| Accounts receivable | 269,197.08 |
| Bills receivable | 36,603.35 |
| Merchandise inventory | 52,402.91 |
| Land and buildings | 40,000.00 |
| Machinery and equipment | 16,460.57 |
| Furniture and fixtures | 4,466.33 |
| Prepaid advertising | 26,455.19 |
| Prepaid taxes and insurance | 1,413.24 |
| Total | <u><u>\$448,005.88</u></u> |

LIABILITIES

| | |
|--|----------------------------|
| Accounts payable | \$ 66,568.63 |
| Bills payable | 152,468.53 |
| Capital stock, preferred (par \$100) | 50,000.00 |
| Capital stock, common (par \$100) | 100,000.00 |
| Surplus | 78,968.72 |
| Total | <u><u>\$448,005.88</u></u> |

An agreement is finally reached, whereby West agrees to sell to the Opulent Company all of the Chimera Company's common stock at its actual book value (as determined by an audit of its books and an appraisal of its assets) in payment for which he is to receive stock of the Opulent Company (at par) to an equal amount. West delivers his own 800 shares of Chimera common and instructs the Opulent Company to purchase, for his account, the remaining 200 shares at the most favorable figure for which it can be bought. It is finally secured at \$75.00 per share. Appraisers and arbitrators are named and you are called in to audit the Chimera Company's books and prepare the statement for final settlement.

You will find that cash, prepaid taxes and insurance, bills payable,

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preferred stock and common stock are correctly stated, as above. Accounts receivable aggregating \$23,641.38 and bills receivable aggregating \$14,342.98 prove to be worthless. The actual value of prepaid advertising amounts to only \$3,197.35. There are unrecorded accounts payable amounting to \$43,237.89. The appraisers decide upon the following valuations:

| | |
|-------------------------------|-------------|
| Merchandise | \$36,341.18 |
| Land and buildings | 40,000.00 |
| Machinery and equipment | 10,000.00 |
| Furniture and fixtures | 2,500.00 |

Prepare the following and embody them in a report to your clients:

1. Corrected balance sheet of the Chimera Chemical Company.
2. Deficiency account of the Chimera Chemical Company.
3. Statement of Willoughby West's account with the Opulent Oxygen Co.

It is then decided that the Opulent Company shall pay into the treasury of the Chimera Company sufficient cash to wipe out the impairment of its capital.

Draft the entries in the journals and cash books of both companies necessary to record all of the foregoing transactions. Also show the accounts of Willoughby West and the Chimera Company as they will appear in the Opulent Company's ledger.

SOLUTION

Journal entries adjusting accounts of Chimera Chemical Co., as appraised, and recording newly discovered liabilities.

| | | |
|-------------------------------|--------------|-----------|
| Deficiency | \$128,968.72 | |
| To Accounts receivable | | 23,641.38 |
| Bills receivable | | 14,342.98 |
| Prepaid advertising | | 23,257.84 |
| Accounts payable | | 43,237.89 |
| Merchandise inventory | | 16,061.73 |
| Machinery and equipment | | 6,460.57 |
| Furniture and fixtures | | 1,966.33 |
| Surplus | 78,968.72 | |
| To Deficiency | | 78,968.72 |

BALANCE SHEET, CHIMERA CHEMICAL CO. AS AMENDED

| ASSETS | | LIABILITIES | |
|---------------------------|---------------------|------------------------|---------------------|
| Cash | \$ 1,007.21 | Accounts payable | \$109,806.52 |
| Accounts receivable | 245,555.70 | Bills payable | 152,468.53 |
| Bills receivable | 22,200.37 | Capital stock: | |
| Merchandise inventory .. | 36,341.18 | Preferred | 50,000.00 |
| Land and buildings ... | 40,000.00 | Capital stock: | |
| Machinery and equip- | | Common | 100,000.00 |
| ment | 10,000.00 | | |
| Furniture and fixtures .. | 2,500.00 | | |
| Prepaid advertising | 3,197.35 | | |
| Prepaid taxes and in- | | | |
| surance | 1,413.24 | | |
| Deficiency | 50,000.00 | | |
| | <u>\$412,275.05</u> | | <u>\$412,275.05</u> |

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DEFICIENCY ACCOUNT

| | | | |
|------------------------------------|---------------------|------------------------|---------------------|
| Accounts receivable | \$ 23,641.38 | Surplus | \$ 78,968.72 |
| Bills receivable | 14,342.98 | Opulent Oxygen Co. ... | 50,000.00 |
| Prepaid advertising | 23,257.84 | | |
| Accounts payable | 43,237.89 | | |
| Merchandise inventory . | 16,061.73 | | |
| Machinery and equip- ment | 6,460.57 | | |
| Furniture and fixtures .. | 1,966.33 | | |
| | <u>\$128,968.72</u> | | <u>\$128,968.72</u> |

The amended balance sheet shows a deficit of \$50,000.00 against a total capitalization of \$150,000.00 of which \$50,000.00 is preferred. The treatment of the deficit depends on the status of the preferred stock. If it is preferred as to assets, the whole loss will fall on the common stock. If not, the loss will be divided pro rata between the two classes, reducing each of them to two-thirds of their original value. In the absence of specific information, it would seem that the latter assumption should be taken, if it were not for the fact that the Opulent Company proposes to pay in cash enough to cover the impairment of the capital. Assuming that the preferred stock is impaired one-third, or \$16,666.67, would necessarily imply that the Opulent Company would pay in that amount for the sake of making good the impairment of preferred stock, in which it had absolutely no interest. It must not be forgotten that the Opulent Company is buying only the common stock of the Chimera Company, and it is inconceivable that it would make a free gift to the preferred stockholders of \$16,666.67. We must therefore conclude that the common stock is impaired \$50,000.00, and is worth only 50% on the books. On this basis, West's account would be as follows, after he had paid the balance due:

W. West

| | | | |
|------------------------|--------------------|------------------------|--------------------|
| 200 sh. Chimera common | \$15,000.00 | 800 sh. Chimera common | \$40,000.00 |
| 500 sh. Opulent | 50,000.00 | 200 sh. " " | 10,000.00 |
| | | Cash | 15,000.00 |
| | <u>\$65,000.00</u> | | <u>\$65,000.00</u> |

The journal entries on the books of the Opulent Company would be,

| | | | |
|---|-------------|-----------|--|
| Chimera Chemical common | \$40,000.00 | | |
| To W. West | | 40,000.00 | |
| for 800 shares Chimera common at 50% book value. | | | |
| W. West | 15,000.00 | | |
| To cash | | 15,000.00 | |
| for 200 shares Chimera common, bought for his account. | | | |
| Chimera Chemical common | 10,000.00 | | |
| To W. West | | 10,000.00 | |
| purchasing from him 200 sh. at 50%. | | | |

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| | | |
|---|-----------|-----------|
| W. West | 50,000.00 | |
| To capital stock, or treasury stock | | 50,000.00 |
| transferring to him 500 shares Opulent Co. stock (from original capital or treas- ury, as may be) in exchange for 1,000 shares Chimera common at 50. | | |
| Cash | 15,000.00 | |
| To W. West | | 15,000.00 |
| repayment by him of advance. | | |
| Chimera Chemical common | 50,000.00 | |
| To cash | | 50,000.00 |
| payment of deficit to bring the stock back to par. The only other account asked for would be on books of Opulent Co. | | |

CHIMERA CHEMICAL CO. COMMON STOCK

| | |
|---------------------------------|-------------|
| W. West, 800 shares at 50 | \$40,000.00 |
| W. West, 200 shares at 50 | 10,000.00 |
| Cash | 50,000.00 |

On the Chimera Chemical Co. books there would be an entry

| | | |
|---------------------------|-------------|-----------|
| Cash | \$50,000.00 | |
| To deficiency | | 50,000.00 |
| received from Opulent Co. | | |

The client to whom the report is to be made would naturally be the Opulent Oxygen Co. The following would be the condensed report:

Mr. John Doe, president,
Opulent Oxygen Co.

Dear Sir:

As instructed by you, I have made an examination of the accounts of the Chimera Chemical Co. and have prepared the following statement of its condition, as shown by its books and as it appears after the adjusting entries have been made in accordance with the report of the appraisers:

| <i>ASSETS</i> | <i>Per Books</i> | <i>As Appraised</i> | <i>Deficiency</i> |
|-----------------------------------|---------------------|---------------------|-------------------|
| Cash | \$ 1,007.21 | \$ 1,007.21 | |
| Accounts receivable | 269,197.08 | 245,555.70 | \$ 23,641.38 |
| Bills receivable | 36,603.35 | 22,200.37 | 14,342.98 |
| Mdse. inventory | 52,402.91 | 36,341.18 | 16,061.73 |
| Land and buildings | 40,000.00 | 40,000.00 | |
| Machinery and equipment | 16,460.57 | 10,000.00 | 6,460.57 |
| Furniture and fixtures | 4,466.33 | 2,500.00 | 1,966.33 |
| Prepaid advertising | 26,455.19 | 3,197.35 | 23,257.84 |
| Prepaid taxes and insurance | 1,413.24 | 1,413.24 | |
| | <u>\$448,005.88</u> | <u>\$362,275.05</u> | |
| <i>LIABILITIES</i> | | | |
| Accounts payable | \$ 66,568.63 | \$109,806.52 | 43,237.89 |
| Bills payable | 152,468.53 | 152,468.53 | Dr. 128,968.72 |
| Capital stock: | | | |
| Preferred | 50,000.00 | 50,000.00 | |

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Capital stock:

| | | | |
|---------------|---------------------|---------------------|-------------------------|
| Common | 100,000.00 | 50,000.00 | 50,000.00 |
| Surplus | 78,968.72 | | 78,968.72 |
| | <u>\$448,005.88</u> | <u>\$362,275.05</u> | <u>Cr. \$128,968.72</u> |

This shows that the common stock is impaired \$50,000.00. The whole loss must fall on the common stock, since the preferred stock is preferred as to assets, and does not lose any of its value until the common stock is exhausted.

This exhibit fixes the price to be paid to Mr. Willoughby West for the stock bought from him and for his account as fifty cents on the dollar. His account will therefore be as follows:

Willoughby West

| | | | |
|------------------------|--------------------|------------------------|--------------------|
| 200 sh. Chimera common | \$15,000.00 | 800 sh. Chimera common | \$40,000.00 |
| 500 sh. Opulent Oxygen | 50,000.00 | 200 sh. Chimera common | 10,000.00 |
| | | Balance | 15,000.00 |
| | <u>\$65,000.00</u> | | <u>\$65,000.00</u> |
| Balance | <u>\$15,000.00</u> | | |

The figures shown in the statement of assets are those submitted by the appraisers and arbitrators. The increase in the accounts payable was discovered from statements sent in by creditors and from an analysis of the inventory, disclosing goods that had been received for which no credits had been made to accounts payable.

Yours very truly,
_____, C.P.A.

NOTE—The importance of determining the status of the preferred stock arises from the fact that if it shared in the impairment the common stock would be impaired only \$33,333.33. This would give the common stock a book value of 66-2/3% and Mr. West would have been entitled to \$66,666.67 of the Opulent Oxygen stock, instead of \$50,000.00.

Book Department

CLUB ACCOUNTS AND THEIR CONTROL By HAROLD TANSLEY
WIRT, F.C.A., *Gee & Co.*, London, 1913. \$1.50.

This publication is intended to prove of value to secretaries and committees of English clubs, and also to explode the theory that any one can manage a club. Incidentally, the author modestly submits the book to members of the accounting profession as a guide when they are called upon to install club accounts, as its theories are in every day use by the best English clubs. The books of account from which the revenue account and balance sheet are prepared, as prescribed by the author, are: cash book; tabular expenditure journal; impersonal ledger (partly ruled in tabular form; tradesmen's ledger; small journal (for impersonal entries, and adjustments); and debenture ledger (if the club has a debenture debt).

The author urges the importance of keeping, wherever possible, a record of the profits made in each department of the club, so as to produce a comparable ratio of percentage of profit to the takings.

A careful reading of this book fails to dispel the thought that our English cousins have made little progress in demonstrating the stewardship of club departmental service coincidentally with the stewardship of employees handling money and property. The accounting processes suggested by the author are practically obsolete in American clubs and have given place to clean-cut and concise methods that are promptly responsive to any desired demonstration of stewardship. American club management is generally vested in standing committees, composed of men or women active in business affairs, who demand the same graphic and comprehensive records for their club that they require in their own business affairs. This has resulted in giving to American clubs the very best accounting thought in the development of routine, accounting methods, and comprehensive statements of results.

HERBERT M. TEMPLE

THE THEORY OF DEBIT AND CREDIT IN ACCOUNTING, by
ROBERT GARDNER McCLUNG. *Morgan, Mills and Company*, Boston,
1913. 16 pages. \$1.00.

Length of title, magnitude of price and abundance of index are the most noteworthy features of a little pamphlet of fourteen pages devoted to a discussion of the theory of debit and credit in accounting by MR. ROBERT GARDNER McCLUNG. The absolute necessity for a publication of a work of this kind does not appear to the casual reviewer. To him it reads more like the introductory chapter of an ordinary text book on accounting. Every worthy contribution to the literature of accountancy should be welcome, but it is much to be doubted if the reception accorded the booklet in question will be as hearty as it might be were the contents greater and the price less.

A. P. R.

Book Department

INCOME TAX GUIDE, By WALTER A. STAUB, C.P.A., *Lybrand, Ross Bros. & Montgomery*, New York, 1913. Fifty cents.

Following enactment of the Underwood tariff bill with its provision for the incidence of a tax upon individual as well as corporate income a mass of literature has been published dealing with the income tax and attempting more or less satisfactorily to explain the meaning of an act which certainly did not err on the side of too great clarity. Many of the banks have issued booklets containing advice to bondholders, and various other institutions have voluntarily come to the assistance of a rather bewildered public, but it must be confessed that the great majority of this expository pamphleteering has served chiefly to make confusion worse confounded. The primary reason for this failure to explain is the evident desire of the authors to display their ability as destructive critics. The act has been roundly belabored; its provisions have been ridiculed; and its inapplicability to the conditions of business has been demonstrated to the complete and serene comfort of complacent writers.

Constructive criticism, however, has not been wholly lacking and in Mr. STAUB's little book we have as lucid and able a discussion of the act as has appeared. He starts with the bold assumption that the act can be applied and proceeds to show how. Naturally he deals only with the act and those regulations under it issued prior to the publication of his book, but he displays a grasp of the law and a confidence in the administration of it which is valuable and encouraging. The set of forms for recording income which is embodied in the book is of great use. The exposition of the law is most sound. There is a modicum of criticism but as a rule the author takes the subject as he finds it and has no violent quarrel with facts. The book is excellent and should be an aid to every payer of income tax.

A. P. R.

A FIRST YEAR IN BOOKKEEPING AND ACCOUNTING By G. A. MACFARLAND AND I. D. ROSSHEIM, pp. 224. *D. Appleton & Co.*, 1913.

As stated in the foreword the endeavors of the authors "have been to lay particular emphasis on the methods of exposition; appeal being made to the understanding rather than to the memory of the student." This is exactly what is needed in the university courses in commerce, and the purpose is laudable. It is my opinion that the method of illustrating principles by specific problems will soon supplant the routine sets so largely in use at present, and it is a pleasure to see a text with such a basis. Too frequently it is assumed that the student knows bookkeeping because he has waded through a mass of tiresome entries. Such routine work drives all ambition and initiative from many a man who begins the work. The authors state "but a small number of students having reference to this volume will eventually reach the summits of accounting, having no desire to follow it as a profession." This is unquestionably true, but the writer is also convinced that one of the great faults with instruction in bookkeeping is that teachers do not

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inspire the student with vision; the student sees only the things at hand and becomes mechanical in his action—he is learning the trade of being a bookkeeper. Certainly no university course in commerce has such an aim in view. The course in bookkeeping is used as a stepping stone in approaching the larger subject of accountancy. Merchandise or trade discount is defined on page 54 as “a consideration given or received for the payment of bills before they are due.” This is a confusion of the terms, trade and cash discount, and it is the latter which the authors have defined. An examination of the text failed to reveal the correct use of the term, “trade discount.” The fact that the old time mixed account with merchandise is used in this book is to be regretted. If universities are to prepare men for entering the profession the accounting work from beginning to end must be properly correlated, so that time need not be wasted in accounting classes in explaining and correcting the methods followed in bookkeeping texts.

In the opinion of the writer, too much attention (three chapters, 24 pages) is given over to single entry bookkeeping and the change from single entry to double entry. Particular attention should be called to the fact that no mention is made in the text of corporation bookkeeping or general corporation subjects, with which the bookkeeper should be familiar. The authors state in the foreword that the text “is designed to provide a full first year’s work in bookkeeping and accounting, for use in higher institutions of commercial training. Certainly not a great deal of time could be given the subject each week if the contents of the book were to suffice for a year’s work, and it is hoped that the number of universities devoting so little attention to training for accountancy is exceedingly small.

F. H. ELWELL.

Correspondence

Accounting Terminology

Editor, The Journal of Accountancy:

Sir: It is an ungrateful task to criticise the work of a committee which has freely given its services to the American Association of Public Accountants, but where severe criticism is bound to arise, it seems desirable that members of the association should be the first to realize the need therefor.

Few who have read the report of the committee on accounting terminology will dissent from the conclusion that it is not worthy of its members or of the accounting profession. It is unnecessary to discuss the report in detail and all that can now be done is to take steps to insure, so far as possible, that the report shall not be regarded by the public

Correspondence

as representative of either the accounting, literary or other qualifications of the general body of accountants in this country. It is solely with this object in mind and with a feeling of deep regret that this letter is written.

Yours very truly,

C. CULLEN ROBERTS.

New York, December 31, 1913.

[We are glad to publish MR. ROBERTS' letter because we believe that the committee on accounting terminology will welcome any reasonable criticism; but it is necessary to point out that the American Association of Public Accountants does not signify its approval of committee reports simply because of their publication in the year book. The reports of committees are generally ordered printed, and it remains for the members of the association to express their views on such reports. The report in question is probably not intended to be the final word of the committee, but is simply a collection of definitions which the committee presents to the association as the result of its efforts during the year. This view of the case is clearly set forth in the introductory portion of the committee's report. *Editor, THE JOURNAL OF ACCOUNTANCY.*]

New York C. P. A. Examinations

Editor, The Journal of Accountancy:

Sir: A solution to question 5, part 2, practical accounting, 35th New York C. P. A. examination having been submitted in the November issue of *THE JOURNAL*, the writer begs to offer his solution of the same problem.

The question at issue, while it speaks of the value of the two stores, at Paterson and Newark respectively, in the writer's estimation could not mean to aim at the net worth of the firm at the dates mentioned in the problem. This viewpoint seems to have been taken by your correspondent from Dallas to judge from the wording of his solution.

By assuming this to be so, he concluded to divide the amount of \$1,500 due to creditors into two even parts in spite of the problem stating:

"Purchases, Paterson store, January to July \$3,325."

This in the writer's opinion seems to imply that all other purchases, whether paid or unpaid, should be charged to the Newark store.

Very truly yours,

PAUL L. LOEWENWARTER.

Announcements

Frank L. Norris and David E. Boyce announce the opening of offices at 30 Church Street, New York, where they will practise under the firm name of Norris and Boyce.

Andrew Hunter, Jr., & Co., certified public accountants, announce the removal of their offices from the American Building to Suite 1022-1023 and 1024 Munsey Building, Baltimore, Md.

Raban & Finlay, certified public accountants, announce the formation of a partnership for the practice of accountancy, with offices at 5 Second Street North, Great Falls, Montana.

J. Porter Joplin, chairman of the committee on professional ethics of the American Association of Public Accountants, was the guest of the Institute of Chartered Accountants of Manitoba at a dinner given in the St. Regis Hotel, Winnipeg, on December 9th. After dinner Mr. Joplin addressed the members of the Institute on the subject of ethics, and a general discussion followed.

The first examination under the C. P. A. law of North Dakota will be held at the state university in Grand Forks, N. D., on January 29th. Applications for this examination should be addressed to the state board of accountancy, (president, Frank L. McVey, president of the university of North Dakota) thirty days before the date of examination.

Arthur E. Andersen and Clarence M. DeLany announce that they will engage in the general practice of public accounting under the firm name of Andersen, DeLany & Co., certified public accountants, with office in Harris Trust Building, III West Monroe Street, Chicago, Ill.

Mr. Anderson retains his connection with Northwestern University.

Elmer L. Hatter, certified public accountant, announces that he has opened offices at 625 Munsey Building, Baltimore, Md., for the general practice of accountancy.

W. F. Weiss and Company, certified public accountants, 170 Broadway, New York, announce that they succeed to, and continue at the same address, the accounting practice of the firm of W. F. Weiss and of Macpherson, Weiss and Company (of New York) the latter firm having been dissolved.

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No. 2

The National Budget*

BY HARVEY S. CHASE

The *Annual Report on the Finances* by the secretary of the treasury was issued to congress three days ago. In this report the "estimates" of revenue and of expenditure for the coming fiscal year, which begins July 1st next, amount to very large sums. The estimates for appropriations of all kinds including the postal service, the Panama canal, the sinking fund, the reclamation fund, the Indian and other trust funds, etc., amount to \$1,108,681,777. These are the figures we see quoted in the newspaper headlines. They are, however, seriously misleading unless careful attention is given to them—as has been given in the secretary's annual report.

In the first place this total includes "the provisions for the sinking fund"—\$60,717,000.† This provision is based on requirements of law that one per cent of the public debt shall be laid aside each year as a "sinking fund" to retire the debt. Therefore, duly each year sixty millions or more in figures are entered in the big account-books of the nation, as an increase of the "sinking fund," but at the same time a corresponding entry is made on the other side of the ledger exactly equalizing it. No money, or securities, or assets of any tangible nature are ever set aside in a true "fund." In other words the entry is solely a "bookkeeping" one, without corresponding value in fact. The

* Extracts from an address delivered December 6, 1913.

† This amount includes not only one per cent (\$11,691,277 for 1913) of the outstanding debt, but also an allowance for interest (\$48,956,520 for 1913) on the grand total of all redemptions prior to 1913. With these additions the "sinking fund balance" at the close of the last fiscal year, June 30, 1913, had reached the astonishing total of \$869,885,041, which is, as stated above, wholly illusory and fictitious.

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amount really has no place in these estimates, if we wish to know what the *actual* expenditures of the government are likely to be.

Deducting this "sinking fund" amount, the total remaining estimates stand at \$1,047,964,777. This remainder includes the Panama canal estimates, which amount to \$26,326,985 and which may be paid from bonds if found advisable to do so. They are extraordinary in character, are "capital outlays" and should be deducted also, as is done on page 27 of the secretary's report. The postal service expenditure, \$306,953,117, is included in the above total, also the reclamation fund and many trust or special accounts which are provided for from special revenues. Many of these trust funds are highly intricate and complicated accounts and it has been the custom of the government for many years to handle them, not as "trusts," but as ordinary revenues and expenditures, meanwhile keeping accurate book-account of each trust, but not attempting to separate the money or securities belonging to each. This has appeared to be the only practicable way to handle these accounts heretofore, although it has long been acknowledged that the custom was open to serious objection, particularly when it is desired to set forth a correct budgetary statement of the government's finances as a whole. It is at present impracticable to separate these trust moneys from the actual revenues of the government itself and therefore an absolutely true picture of the national budget cannot yet be drawn.

We can approximate it, however, within reasonable limits. Deducting, now, the Panama canal and the postal service estimates, the remainder of the proposed expenditures for 1914-15 stands at \$714,684,675. From this sum the secretary's report deducts \$12,684,675 more, for the stated reason that a considerable part of the estimates for "public works" will not be expended during the year but will be expended in later years. No mention is made, however, of similar public works of previous years which may be continued this year and, if so, must be paid out of this year's revenue.

This fault, if it be a fault, is a matter of no material significance because the estimates, both of revenue and of expenditure, as now made, will be very considerably altered in the next annual report—if experience is a guide—and the final actualities of any

The National Budget

fiscal year will be found quite different from the estimates which have been made in previous years in prophecy of the year under consideration.

I have prepared some figures on previous years for comparison with 1914-15 and find the following interesting results: Taking the fiscal year which ended June 30, 1913—the subject of the secretary's present report—I find that the actual revenue (ordinary) is given as \$724,111,000, round figures; while the estimate of this revenue made by the treasury in 1912 (for 1913) was \$711,000,000; and the estimate of this same revenue made the year before, in 1911 (for 1913), was \$667,000,000. The first (actual) is greater than the second by about two per cent, while the first (actual) is greater than the third by about eight and a half per cent, or fifty-seven millions of dollars, which represents the increase of actual revenue collected in 1912-13 over the estimate of that revenue made in 1910-11.

I have also compared the fiscal year 1911-12 on the same basis. The actual revenue was \$691,778,000, round figures. The estimate of it in 1911 was \$666,000,000, and the estimate of it in 1910 was \$680,000,000—again a difference of four per cent, and one and two-thirds per cent, respectively. These results, you see, are pretty good guesses on the whole and the chief guesser in one of the divisions of the treasury department deserves much credit. How he will come out next year, when the tremendous changes in revenue—caused by the new tariff, the new corporation tax and the new income tax—are all at work, remains to be disclosed.

So much for the estimates on the revenue side of the "budget." Now, for the other side—the expenditures. We have seen that the total ordinary expenditures—which include capital outlays of probably \$175,000,000 or more for lands, buildings, equipments, stores, etc.—are estimated at about \$715,000,000 for 1914-15, while the ordinary revenues are estimated at \$728,000,000, subject to variation of from two to eight per cent, according to recent years' experience.

I have compared the actual expenditure for 1913 (June 30th) with the estimates of that expenditure made in 1912 and in 1911 and they differ by twelve millions and forty-five millions respectively. For the fiscal year 1912 the expenditure estimates differed from the actual by less than one million and by twenty-

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four millions respectively, which are small percentages of the grand total.

For the current fiscal year—ending June 30, 1914—the estimates made in 1912 and in 1913 vary widely. The revenue estimate made last calendar year (1912) for this fiscal year (1914) was \$710,000,000; while the estimate for the same made this year (1913) is \$736,000,000, a difference of twenty-six millions. On the expenditure side, the estimate of 1914 made in 1912 was \$732,556,000, while as made in 1913 it is \$701,900,000. These differences when added together make a total difference of about fifty-five million dollars in the results of the fiscal transactions *as estimated*, and they change an expected deficit of \$22,556,000, for 1914 (made in 1912), into an expected surplus of \$34,100,000 for 1914, as made now. All of which goes to show how difficult it is to calculate or guess correctly concerning the revenues and the expenditures of such huge governmental machinery as our nation now comprises.

FINANCES AT THE BEGINNING OF THE NATION, 1789

Few statements are more surprising, indeed bewildering, than those drawn from comparisons of national financial transactions at the beginning of our government in 1789, with the present figures in this recent report of Secretary McAdoo. The earliest budgetary statement of our government was submitted by Alexander Hamilton, the first secretary of the treasury, on January 9, 1790, in a report to the house of representatives, entitled *A Report on Public Credit*. This report included a *General Estimate for the Services of the Current Year*, as follows:

FIRST BUDGET STATEMENT

| | |
|--|--------------|
| <i>Estimate of Expenditure:</i> | |
| Civil list | \$254,892.73 |
| War department | 155,537.72 |
| Military pensions | 96,979.72 |
| Total | \$507,410.17 |
| "Provisions for the foreign department and other arrangements" | 600,000.00 |

Included in the "civil list" above are the "requirements for

The National Budget

the treasury department"—\$25,900; of which the secretary's salary is stated as \$3,500, and that of the "assistant of the secretary," \$1,500.

THE SECOND BUDGET STATEMENT

On January 2, 1795, Secretary Hamilton submitted a report to the house entitled "*Public Credit, No. 2*," and in this he gives a *Comparative View of Annual Credit, Revenue and Expenditure* based on the actual receipts for the year 1793, together with estimated additional revenues for 1795, *viz.*:

"CURRENT REVENUE"

| | |
|--|-----------------------|
| "Total permanent revenue" | \$4,692,673.83 |
| "Temporary revenue" (special duties, etc.) | 1,859,626.91 |
| Total | <u>\$6,552,300.74</u> |

"CURRENT EXPENDITURE"

| | |
|--|-----------------------|
| Interest on foreign and domestic debts | \$3,143,743.18 |
| Expenses of civil department | 475,249.53 |
| Expenses of military department | 1,311,975.29 |
| Pensions | 85,357.04 |
| Expenses of naval department | 441,508.80 |
| Expenses of lighthouses, etc. | 24,000.00 |
| Total | <u>\$5,481,843.84</u> |

| | |
|--|-----------------------|
| Excess of revenue beyond expenditure | <u>\$1,070,456.90</u> |
|--|-----------------------|

This excess he proposed to use:

| | |
|--|------------|
| For sinking funds | 608,134.64 |
| For yearly installments on foreign loans | 200,000.00 |
| For increased interest and arrears | 120,130.12 |

| | |
|-------------|----------------------|
| Total | <u>\$ 928,264.76</u> |
|-------------|----------------------|

| | |
|---------------------------------------|----------------------|
| Leaving a net excess of revenue | <u>\$ 142,192.14</u> |
|---------------------------------------|----------------------|

THE THIRD BUDGET STATEMENT

This was prepared by Albert Gallatin, secretary of the treasury, under an act approved May 10, 1800. The requirements of this act have continued to this day, and the treasury's *Annual Report on the Finances* has followed the original form laid down by Gallatin in 1801. His estimates of revenue and of expenditure for the fiscal year (1802) were as follows:

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"REPORT ON THE FINANCES"

Dated December 18, 1801,

By Albert Gallatin, Secretary of the Treasury.

ESTIMATES FOR 1802

Current Revenue

| | |
|---|------------------------|
| Duties | \$ 9,500,000.00 |
| Internal duties | 650,000.00 |
| Proceeds of sales of public lands | 400,000.00 |
| Duties on postage | 50,000.00 |
| | <hr/> |
| "Temporary revenues" | \$10,600,000.00 |
| | 3,000,000.00 |
| | <hr/> |
| | <u>\$13,600,000.00</u> |

Current Expenditure

| | |
|---|------------------------|
| Estimates for appropriations (other than debt), viz.: | |
| Civil | \$ 780,000.00 |
| Intercourse with foreign nations | 200,000.00 |
| Military establishment | 1,420,000.00 |
| Navy department | 1,100,000.00 |
| | <hr/> |
| Total | \$ 3,500,000.00 |
| Demands of treaties with Great Britain and France | 3,000,000.00 |
| | <hr/> |
| | <u>\$ 6,500,000.00</u> |
| | <hr/> |
| Excess of revenue "available for payment of interest and reduction of debt" | \$ 7,100,000.00 |
| Savings of expenses by effected reductions from war prices. | 200,000.00 |
| | <hr/> |
| Total available for debt purposes | \$ 7,300,000.00 |
| Interest and annual payments on Holland debt, etc., as estimated | \$ 7,100,000.00 |
| | <hr/> |
| Final surplus (if "savings" are correct) | \$ 200,000.00 |

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Comparison of Appropriations of 1790 with those of 1914-15

APPROPRIATIONS

| | 1790 | 1914-15 |
|--|----------------|-----------------------|
| Interest on debt | \$1,413,043.23 | \$ 22,900,000.00 |
| Reduction of debt | 1,453,549.15 | (1) |
| Pensions | 96,979.72 | 169,150,000.00 |
| Military | 194,744.72 | 105,937,544.26 |
| Naval | (2) | 139,831,953.53 |
| Congress, legislative | 203,167.28 | (3) 6,814,772.75 |
| Executive | | (4) 29,035,518.20 |
| Judicial | | 1,242,110.00 |
| "Civil List" | 234,091.86 | |
| Agriculture | | (5) 19,061,332.00 |
| Library and garden | | 718,558.75 |
| Ministers abroad | 80,000.00 | (6) 4,447,042.66 |
| Indian affairs | 20,000.00 | (7) 17,608,865.06 |
| Public works | (8) | (9) 69,955,107.53 |
| "Permanent annual," other than Indians, sinking fund and interest | | (10) 40,179,407.00 |
| Lighthouses | 49,252.52 | 1,699,530.00 |
| Census | 21,850.00 | 1,709,720.00 |
| Miscellaneous | 78,485.20 | (11) 84,393,213.28 |
| Totals | \$3,845,532.68 | (12) \$714,684,675.02 |

- (1) "Sinking fund" omitted, as it is merely a book account of no actual value.
- (2) "Naval" of 1789 was included in "military."
- (3) Legislative, 1915, exclusive of Congressional Library and Botanic Garden.
- (4) Omitting "census" and portion of "lighthouses" (below).
- (5) Usually included with legislative as they are under control of congress.
- (6) "Foreign intercourse."
- (7) Including "Indian trust funds," "proceeds of labor," etc.
- (8) Included in "civil list" and in "military."
- (9) Excluding "lighthouses," given below.
- (10) Excluding "Indian trust funds," etc.; also sinking fund and interest.
- (11) Includes much which should be included in "civil list," military, etc., above.
- (12) Excluding Panama canal, postal service and sinking fund.

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The totals are startling in their differences; 1790 being only a little over one-half of one per cent of the total for 1914-15.

Comparison of 1802 with 1915

| | |
|--|------------------|
| Ordinary estimates of expenditure by Albert Gallatin for the year 1802 | \$ 3,584,147.18 |
| Estimates for interest and debt payments | 7,100,000.00 |
| Special expenditure in fulfilling treaties | 3,000,000.00 |
| Total for 1802 | \$ 13,684,147.18 |
| Total for 1914-15, as exhibited above | \$714,684,675.02 |

A REAL "BUDGET"

The United States government has never had a real budgetary statement of its prospective expenditures and revenues in detail. It has had rough estimates of its revenues and very detailed estimates of its expenditures, but these have never been presented to congress by the secretary of the treasury or by the president in the form of a true budget. The reasons for this are many and complicated, one important reason being that our revenue laws heretofore have looked to the "protection" of manufacturing and industry rather than to revenue requirements solely. Now that our tariff laws have been reduced and we have embarked upon the troubled sea of direct income taxation, the necessity for true budget procedure will become more and more emphatic with each year.

It is time, therefore, to get a clear understanding of what "budget procedure" is and to comprehend how it must be applied in our government's finances. To make these difficult matters as plain as I am able to make them, I refer to the estimates for the current year, which ends June 30th next.

Please note the total of *estimates* is \$1,110,000,000 in round figures. You should recognize the contrast between the amounts under the appropriation bills and the same totals analyzed differently (see page 94). Note the contrast between "military functions" \$452,000,000 (including naval and pensions) and "civil functions" (omitting postal service)—about \$207,000,000.

This contrast—"military" about two and a quarter times as much as "civil"—is sufficiently surprising, but there are still other factors. We may consider that the expenditures under the head of "general functions" apply to both civil and military

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and that they correspond to "overhead" or "general management expense and fixed charges" in a business enterprise. A considerable part of these "general function" expenses is due to public debts contracted for military and naval requirements heretofore, so that the true charge to "military," as against "civil," should be increased by thirteen millions for interest and by thirty-seven millions or more for real sinking funds, supposing that the debts are to be actually paid at maturity. Charging these to military, the remaining costs of "overhead" may be considered as applying equally to civil and to military—one-half to each—or about fifty millions more to be added to military costs in this country (always including "naval" and "pensions"). The grand total of all these military items is about five hundred and fifty millions of dollars per annum, and this is for military expenditures in a time of peace. In other words, out of a grand total estimate of about eight hundred million dollars * for all expenditure of the current year (excluding postal service and Panama canal, but including true "sinking funds") the requirements for military purposes, past and present, amounted to about seventy per cent or \$550,000,000.

The mere announcement of these figures is sufficient to arrest the attention of every intelligent man and woman in the country. Such figures cannot be unearthed by a simple reading of our present appropriation bills or from our present method of stating our government accounts in the annual reports of the treasury or elsewhere. They can be found only by careful analysis and re-analysis of the proposed expenditures, separating *civil* matters from *military* matters and finally aggregating the totals. When this is done, a reasonably accurate picture of our financial requirements and of the various purposes for which expenditures are proposed, can be had. This result is one of the important results which will flow from the adoption of real budgetary analyses and statements for the government as a whole; as well as for each department and division of it in detail.

It is evident that the public ought to be provided with such analyses; that congress should have them; that the president and the executive departments need them most of all. No gen-

* Reduced in the new estimate for 1914, made recently, by about thirty millions of dollars, or to \$770,000,000—including sinking fund, \$80,000,000.

eral financial policy can be intelligently entered upon—either for raising revenue or for making appropriations—until the details of preparing and aggregating estimates are planned in this manner and correctly segregated as to *purposes* or *functions* of government. When this is done regularly, and when sufficient time has elapsed for safe comparisons with the experiences of prior years to be drawn, then the president of this republic, when he reports to congress upon the “state of the Union,” will be enabled to foresee with reasonable accuracy what revenue will be available and to conclude how this revenue should best be expended. He must give due prominence to fixed charges which cannot be avoided; such as interest, trust funds, provision for public debt redemption, etc. Having allowed for all these permanent charges and for other unavoidable expenditure, the executive might then recommend to congress and the people how, in his judgment, the remaining revenue should be expended most advantageously, and in what general proportions this remaining balance of revenue should be divided between the functions of government, up to that point unprovided for. Here he could well discuss at some length the advisability of spending more for some purposes, like promotion of agriculture or commerce or education, while emphasizing the necessity for retrenchment in other expenditures, if a deficit of revenue is not to be faced. Then, if it is evident that the revenues, as estimated, will not provide for the expenditures which are deemed unavoidable or necessary, the executive would point out what this deficiency of revenue is likely to be and would call the attention of congress to the importance of finding new sources of revenue to meet these conditions.

By such means students of government and the intelligent public would promptly come to understand the financial conditions of the nation; and then questions relating to revenue, as well as to expenditure, would assume their rightful importance and have a most salutary effect upon the average citizen, as well as upon our law-making and our executive departments.

If this diagnosis is correct, we may well wish that the day of the *true budget* will soon dawn.

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BUDGET OF THE UNITED STATES OF AMERICA

CLASSIFIED BY PURPOSES OF EXPENDITURE, FUNCTIONS OR ACTIVITIES

I. MILITARY PURPOSES. (INCLUDING NAVAL.)

| | |
|--|--------------------|
| Defense by land | \$ 102,556,165 |
| Defense by sea | 146,615,092 |
| Pensions, retirements, veterans' homes, etc. | 203,394,808 |
| | <hr/> |
| | \$ 452,566,065 |
| Interest and sinking-fund provisions relating to Public Debt for military purposes | 50,000,000 |
| | <hr/> |
| TOTAL, MILITARY PURPOSES | 502,566,065 |
| | <hr/> <hr/> |

2. CIVIL PURPOSES.

| | |
|---|-----------------------|
| Providing facilities for transportation: | |
| Panama Canal | 30,174,432 |
| Rivers and harbors | 56,766,992 |
| Other | 29,903,114 |
| | <hr/> |
| Total, facilities for transportation | \$ 116,844,538 |

| | |
|--|------------|
| Promotion of welfare of— | |
| Agriculture, forestry, etc. | 37,372,040 |
| Indians, and other Wards of the Nation | 14,018,907 |
| Public health | 7,817,342 |
| Education, recreation, etc. | 5,736,545 |
| Medium of exchange, coinage, currency, etc. | 4,584,555 |
| Laboring classes, Dept. of Labor, etc. | 4,372,805 |
| Foreign relations, etc. | 4,341,688 |
| Commerce and banking regulation | 3,023,659 |
| Defectives, dependents, etc. | 2,622,487 |
| Patents and copyrights | 2,242,691 |
| Meteorological research, etc. | 1,712,490 |
| Trading, mining, etc. | 930,439 |
| Census, etc. | 765,060 |
| Standards of measurement, etc. | 612,395 |
| | <hr/> |

TOTAL, CIVIL PURPOSES *\$ 206,997,641

Postal service\$ 276,983,944

3. GENERAL PURPOSES ("Overhead," fixed charges, and management).

Executive:

General direction and control:

| | |
|--|-----------|
| The Executive Office | 199,040 |
| General accounting and auditing (Treasury) | 1,947,010 |
| Civil Service and other commissions | 690,075 |
| | <hr/> |

Total, "general direction," etc.\$ 2,826,125

* Excluding "postal service payable from postal revenues."

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| | |
|---|-------------------------------|
| Departmental administration | 20,813,892 |
| Administration of the finances: | |
| Interest on public debt | 22,860,000 |
| Sinking-fund provisions | 60,685,000 |
| Other | 17,945,273 |
| Operation and maintenance of offices, buildings, grounds, etc. | 21,265,902 |
| Supplies, purchased and manufactured | 553,527 |
| Reference purposes, Congressional Library | 593,300 |
| Distribution of documents | 251,424 |
| Other | 33,300 |
| Detection of crimes, legal advice, etc. | 3,858,890 |
| Total, executive (general purposes) | <u>\$ 151,696,633</u> |
| Legislative: | |
| The Senate, House, Joint Committees, etc. | 8,660,366 |
| Judicial: | |
| Supreme Court and other U. S. courts | 5,741,313 |
| TOTAL, GENERAL PURPOSES | <u>\$ 166,098,312</u> |
| Less: Interest and sinking-fund for military purposes, included in "I" above | 50,000,000 |
| Net total, general purposes | <u><u>\$ 116,098,312</u></u> |
| 4. CONTRIBUTIONS TO LOCAL GOVERNMENT. | |
| District of Columbia and Territories | <u>\$ 7,978,410</u> |
| Total, all purposes | <u><u>\$1,110,624,372</u></u> |

* Excluding "postal service payable from postal revenues."

Savings Bank Audits

BY GEORGE L. BISHOP, C. P. A.

Savings banks, so-called, may be divided into two classes: first, the private savings bank, which is owned by shareholders who receive the profits earned by the use of the depositors' moneys after the payment of the usual and ordinary expenses of the bank and the interest paid to depositors according to the agreement entered into with them by the bank; in the east this form of savings bank is not common, its place being taken somewhat, by the savings department of trust companies and state banks; while the second class, the mutual savings bank, has thrived in the older sections of the country; is deservedly popular, and is a tremendous factor in the development of the community wherein it is located.

Properly speaking, savings banks do not conduct a banking business, and such institutions are not banks in the strict sense of the word. When a man makes a deposit in a commercial bank he intrusts the funds to it for its own use. It makes him its creditor. He is entitled to no increment from the use of the funds unless the bank has agreed to pay him interest, and has only a claim upon it for the amount due him. A savings bank takes deposits not for its own use, but for safe keeping and the sole use and benefit of the depositors. The prime consideration is safety, not profit or income. * * * The entire increment over and above the expense of management belongs to the depositors. There may be a surplus fund accumulated as security against the depreciation of investments or other contingencies, but this remains the property of the depositors, and is for their security. It is in no sense "undivided profits" of the bank *

It is with this second class, or the mutual savings bank, I purpose to deal in this article.

The general idea of savings institutions owes its origin to SAMUEL WHITBRED who, in his long speech before the house of commons in the year 1807, pointed out the way by which the savings or surplus earnings of the working classes might be conserved, protected, and increased for their benefit. The idea spread rapidly in Great Britain, and considering the means of communication between the countries at that time, was quickly taken up in America.

The history of these institutions portrays the progress of

* *The Modern Bank.* FISKE.

communities, marking the thrift and frugality of the people, and by their development adding to the wealth of the country far beyond that ever added to any nation by conquest of arms. There is no better barometer of business conditions than the record of deposits in these banks. These banks are rightly considered as "sacred institutions" and every safeguard which may be thrown around them to protect the interests of the depositors should be the first thought of our legislators; and for such protection, Massachusetts and a few other states have enacted laws requiring the auditing of savings banks by certified public accountants.

The first mutual savings bank in this country, if not in the world, was chartered in Massachusetts, December 13, 1816, under the title, which has continued to the present day, of "The Provident Institution for Savings in the Town of Boston." Although the Philadelphia Savings Fund Association began to receive deposits a month or two before the charter was granted to the Provident Institution, it did not receive its charter until after the Provident Institution had been chartered by the state of Massachusetts.

On October 31, 1912, The Provident Institution for Savings in the Town of Boston reported assets of over \$51,000,000.00, with 104,476 depositors, having an average account of \$475.06. The income for the year is reported as \$2,123,678.00.

The largest mutual savings bank in the United States is the Bowery Savings Bank of the City of New York, having assets of over \$100,000,000.00, although the original charter of this bank limited its deposits to \$500,000.00, because it was then thought that a sum larger than that could not properly and safely be invested.

At present there are some 640 mutual savings banks in the United States; in the New England states 420, or about two-thirds of the total number of these institutions in operation; in the middle eastern states they number about 200; in the middle western about 20; with one each in West Virginia and California; the total resources of these 640 banks being about three and a half billions of dollars. Of the 400 banks in the east, 194 reported to the banking department of the commonwealth of Massachusetts on October 31, 1912, assets of over \$900,000,000.00; the 2,200,900 accounts averaged deposits of \$381.04.

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The gross income of these banks for the year was \$39,201,251.00. The ordinary dividends averaged 3.91%, calling for a division of \$30,514,820.00.

These figures are quoted to present some idea of the magnitude of the business transacted by these mutual institutions and of the tremendous amount of money which may be represented by the small savings of the people.

In Massachusetts twenty or more persons may receive a charter from the state for the organization of a savings bank, to receive savings deposits and to invest them. These corporations are a self-perpetuating body; they elect their own successors, the president of the bank, and the trustees who are the active managers or directors of the bank. (The depositors, as such, have no voice in the election of officers or in the management of the affairs of the bank.) The trustees elect the treasurer and other officers of the corporation, the investment committee which really is an executive committee, and the auditing committee whose duty it is to see that the affairs of the bank are honestly conducted.

It is interesting to note in this connection that the trustees of the first bank chartered by the state agreed to give their services for the promotion of the interests of the institution without remuneration, and this practice has continued down to the present day.

The law carefully designates the manner of investing the deposits, and only high class investments, which after thorough investigation have been passed upon by the bank commissioner, may be held by the bank. Investments consisting of first mortgages of real estate, government, state, and various municipal bonds, the bonds of certain high class railroad and other public utilities may be held, and loans with collateral and loans with personal security approved by the investment committee may be taken.

In Massachusetts the only stocks which may be held are those of banks located in the New England states and incorporated under the authority of the United States, or the stock of a trust company incorporated under the laws of and doing business in this commonwealth.

A sum not more than five per cent of the deposits and not exceeding \$200,000.00, with the approval of the bank commis-

sioner may be invested by a bank in the purchase or construction of a suitable building for the transaction of its business.

A savings bank may hold real estate acquired by the foreclosure of a mortgage but all such real estate must be disposed of within five years after the title has become vested in the bank. It may hold stocks and bonds or other securities acquired in settlement of indebtedness, but such securities must be disposed of within five years after being acquired, except that upon petition of the board of investment, and for cause, the bank commissioner may grant an additional time for the sale of such securities or properties.

In addition to the annual examination made by the bank commissioner's department, which is an examination for the purpose of ascertaining the condition of the bank at a certain date, the law requires that:

At the first meeting after their election the trustees shall appoint an auditing committee of not less than three trustees, of which committee neither the treasurer nor more than one member of the board of investment shall be members, who shall at least once during the twelve months following their appointment, and oftener if required by the commissioner, cause to be made at such time as the commissioner may determine, in such form and manner and by such certified public accountant not connected with said bank as shall first be approved by the commissioner, a thorough examination and audit of the books, securities, cash, assets, liabilities, income and expenditures of the corporation, including an accurate trial balance of the depositors' ledger, for the period elapsed since the preceding examination and audit, or for such other period as the commissioner may prescribe. The said accountant shall personally direct and supervise the making of said examination and audit except that, with the consent of the commissioner, he may verify a trial balance of the depositors' ledger made by the bank within six months, and with the consent of the commissioner, such assistance as shall be necessary may be furnished by the bank. The accountant shall report to the auditing committee the result of his examination and audit, and at the next meeting of the trustees thereafter the committee shall render a report which shall be read, stating in detail the nature, extent and result of the examination and audit, and their report and the accountant's report shall be filed and preserved with the records of the corporation. The committee shall file with the commissioner a copy of the report of the accountant within ten days after its completion. The certified public accountant and the auditing committee shall certify and make oath that the reports made by them under this section are correct according to their best knowledge and belief. If the committee fails to cause to be made an examination and audit, including an accurate trial balance of the depositors' ledger as herein provided, the commissioner shall cause them to be made by a certified public accountant in such form and manner as he may prescribe, and the expense thereof shall be paid by the bank.

The foregoing section of the law was placed upon the statute books in 1910. Before that time few of the banks were

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examined by accountants. The examinations made by the bank commissioner and by the auditing committees were depended upon for proof of the accuracy of the transactions entered upon the books. The difficulties experienced were so few and so far between that the depositors felt assured that their interests were being safeguarded in every particular.

Early in January of 1910 the people of the state were startled by the disclosure of a serious defalcation in one of their "sacred institutions," a defalcation which had continued over a long period of years and which reached the enormous sum of over \$350,000.00, making, with the loss of earnings on the sums wrongfully diverted, a total loss to the depositors of that bank of over half a million dollars.

Coming at a time when the legislature was in session the matter received the attention of that body. According to a provision of law giving authority for the examination of savings banks and their officers by a committee of the legislature appointed for that purpose, a committee was appointed to inquire into the circumstances surrounding this defalcation; to report to the general court the extent of the defalcation, the times when such wrong doing may have occurred, the methods used by the defaulter to conceal his acts, and, further, to report such amendments to the law as would prevent a recurrence of such loss to depositors.

The committee, among other amendments, reported the provision for the auditing of these banks by certified public accountants as set forth in the foregoing extract from the law, and this requirement is in force today, although in 1912 the law was further amended so that now when requested by the auditing committee, the bank commissioner may make such examination and audit of the books, securities, cash, assets, liabilities, income and expenditure of the bank; the expenses of the audit to be borne by the bank.

All the examinations made by certified public accountants within this state are under the direct supervision of the bank commissioner who, upon approving the appointment of an accountant by the auditing committee, issues to him a circular letter of instructions and furnishes a blank report form upon which to make the report of the examination; and the department is in very close touch with all the work performed by

the accountants of the state in the examination of the savings banks. We are safe in stating that to the best of our knowledge and belief the interest of the depositors of the savings banks in the commonwealth of Massachusetts are protected to the uttermost. The instructions of the bank commissioner properly followed make for the complete audit of the transactions of the savings banks.

In what follows it is largely to be assumed that adherence to the requirements of the laws covering savings bank investments, duties of officers, and the general business of the bank will be tested and checked up by the bank commissioner's department, while the accountant will make certain the accuracy of the transactions as recorded upon the books of account. At the same time, however, the accountant should have such familiarity with the laws and with savings bank practice as will enable him readily to determine, independent of the bank commissioner's investigation, that the affairs of the bank are being continued along proper lines, and in conformity with the rules and regulations laid down for their government.

The system of accounts in savings banks is not at all complicated. The main books of record consist of:

A *General Ledger* which contains all the accounts, excepting, of course, the accounts with depositors, the controlling account for which is contained within this ledger;

A *Cash Book* which may show columns under appropriate headings for the active general ledger accounts and which often contains journal entries;

A *Journal* which may be used only for true journal entries or which may be used as a summary of transactions from the cash book.

A *Record of Deposits and Payments* which, in the smaller banks are termed the counter books, the deposits being entered directly upon the deposit books in detail, showing the name of the depositor, number of account, amount deposited; the payments being entered on the draft books, showing the number of account, the amount of the draft and the receipt of the amount by the depositor. The totals of the deposit and draft books are carried daily or monthly to the cash book.

In the larger banks the deposits and payments may be made by means of deposit and draft tickets or slips which are filled

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out by the depositor and entered by the tellers upon their records. These records differ in form, some of them being loose-leaf books for deposits and payments, the slips being sorted according to the ledgers and entered upon the record according to such divisions, in order that the controlling accounts for each ledger may readily be made up. One form with which the writer is somewhat familiar consists of sorting the slips according to the ledgers and summarizing the amounts of deposits and payments by the use of a split key-board adding machine which lists the number of account, the amount of the deposit or payment, taking a total for each ledger; the grand total of the day's work being carried into the cash book.

An *Investment Register* showing the investments made by the bank, grouped according to classes and following the interest dates.

A *Loan Register* showing number of loan, name of borrower, amount of loan, rate, and ordinarily entered according to interest dates, with columns for entering payments of principal and interest, and usually arranged to carry the transactions of two or more interest periods.

Depositors' Ledgers which run numerically, each deposit account being known by number, and carried either in bound books with from two to six or more accounts to the page, in loose leaf ledgers, or upon the familiar card ledgers. Depositors' ledgers usually have columns for deposits, payments, and balance, the new balance being entered after every transaction; the interest credited to the account, if entered in red ink, shows plainly enough this transaction.

Insurance Records in various forms showing the covering of mortgaged properties.

Investment Committee's Minute Book showing the record of the loans examined and passed upon by this committee.

Trustees' Minute Book, being a record of the doings of that board.

A *Collateral Record* showing the collateral deposited against loans and the value of the items.

The form of statement of condition or general trial balance which the accountant is expected to draw off, prove, and report to the bank commissioner is given below:

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..... Mass.,191....
To the Auditing Committee of the

..... Saving Bank
I hereby certify, that, in accordance with the requirements of law and the instructions given by the Bank Commissioner in his circular letter No. 123, I have made a thorough examination and audit of the affairs of the.....Savings Bank of for the period beginning 191...., and ending191....; that to the best of my knowledge and belief, the transcript of general ledger balances shown below truly exhibits the financial condition of the bank as disclosed by its books at the time stated, and that the annexed report, schedules and statements are true and correct.

.....
Certified Public Accountant.
COMMONWEALTH OF MASSACHUSETTS, } Subscribed and sworn to before
..... ss. } me thisday of.....191....
.....

..... Savings Bank of
Transcript of General Ledger Balances at the close of business.....191...

| ASSETS | \$ | LIABILITIES | \$ |
|---------------------------------------|----|--------------------------------------|----|
| 1. Public Funds, Bonds and Notes, | | 1. Deposits, | |
| 2. Railroad Bonds and Notes, | | 2. Guaranty Fund, | |
| 3. Street Railway Bonds, | | 3. Profit and Loss, | |
| 4. Boston Terminal Co. Bonds, | | 4. Interest, | |
| 5. Telephone Co. Bonds, | | 5. Discount and Interest prepaid, | |
| 6. Bank and Trust Co. Stocks, | | 6. Suspense Account, | |
| 7. Securities acquired for debts, | | 8. Due on Uncompleted Loans, | |
| 8. Loans on Real Estate, | | 7. Rent, | |
| 9. Personal Loans to: | | 9. Bills Payable, | |
| a. Three or more individuals, | | 10. Other Liabilities, giving items: | |
| b. Corporations, | | a. | |
| c. Mass. Public Service Corporations, | | b. | |
| d. Railroad Corporations, | | | |
| e. Collateral Loans on: | | | |
| 1. First Mortgages of Real Estate, | | | |
| 2. Bonds and Notes, | | | |
| 3. Books of Savings Banks, | | | |
| 4. Railroad Stock, | | | |
| 5. Life Insurance Policies, | | | |
| 6. Other Securities, | | | |
| 10. Real Estate by foreclosure, | | | |
| 11. " " in possession, | | | |
| 12. " " for banking purposes, | | | |
| 13. Expense Account, | | | |
| 14. State Tax " | | | |
| 15. Taxes and Insurance paid on Mort- | | | |
| gaged Properties, | | | |
| 16. Premium Account, | | | |
| 17. Furniture and Fixtures, | | | |
| 18. Suspense Account, | | | |
| 19. Other Assets, giving items: | | | |
| a. | | | |
| b. | | | |
| 20. Deposits in Banks and Trust Cos., | | | |
| 21. Cash and Cash Items, | | | |
| TOTAL ASSETS, | \$ | TOTAL LIABILITIES, | \$ |

The audit should be started either at the close of a day's business or at the opening of business in the morning, preferably the former, since beginning the examination at the close of business and proving the cash and the transactions of that

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day will disclose any difference which may exist before the staff has had an opportunity of correcting their work, and affords the accountant a better idea of the accuracy with which the transactions are handled than can be had by starting the examination at the opening of business.

Upon entering the bank the accountant should take possession of the cash, securities, collateral, mortgage notes, etc., sealing such items as he may not be able to examine at once and keeping them under seal until the statement has been proven. When the securities, collateral, etc. are deposited in safety deposit vaults outside the bank the boxes should be ordered sealed until released by the accountant. While the counting of the cash is progressing a member of the staff should draw off a statement of the bank as at the opening of the bank that day. The form may be provided beforehand and this working sheet should have columns for entering the day's transactions, with the balance at the closing of the day's business.

The cash should first be "sized up or proven in bulk" and the total reconciled with the amounts called for by the cash book after adjusting the day's transactions, when the packages of bills may be proven to such an extent as may be considered necessary by the accountant in charge. Where one dollar bills are put up in packages of twenty-five, if the accountant wishes to prove these packages, there is not the slightest objection to his doing so.

All cheques found on hand should be listed and deposited by the accountant in a depository bank with instructions that he be notified in case any of the items are returned for any reason. All cash memoranda, expense bills or other items carried as cash should be listed and the propriety thereof established.

Depository banks should immediately be requested to send a statement of account, with vouchers, to the accountant in care of the bank, and the transactions with the depository banks for the period should be checked to such extent as the system in use and the circumstances may make necessary. The accountant should see that the deposits with other banks do not exceed the limits fixed by law.

The footings of deposit and payment records should be proven for the period under examination, and the totals checked to the cash book. Where deposit and payment slips are used

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the method of accounting for deposits and payments should be examined carefully and the entry of the amounts from these slips to the summary sheets tested in such a manner as the experience of the accountant will indicate to be necessary.

In a bank of any size the mortgage notes are usually placed in one file, or series of files, and the mortgage deeds and insurance policies in another file. The usual method is to enclose the mortgage note in a cover or "skin" showing the number of loan, the name of mortgagor, the amount of the loan, with the date and amount of payments of principal. The total of the loan should be listed on an adding machine from the amount shown upon the "skin" and if all entries of payment of principal have been made upon the "skin" the total should agree with the amount of the loan called for by the statement. The total having been proven, the notes should be examined in detail and the payments of principal and interest as shown by the endorsement on the notes checked to the loan register. At the same time the amounts on the adding-machine tape should be checked as each note is examined, so that when the notes have been checked to the loan register the accountant will have in his possession a record of having examined all the notes called for by the statement. In the smaller banks if there is no satisfactory loan register, it is well to construct such a record which should remain in the possession of the accountant. The use of this record will enable him to follow the loan in detail upon subsequent examinations with the certainty that every item is accounted for.

The entries in the register for the period should be checked to the cash book.

Advances on "construction loan" should be vouched by receipts of the borrower or by means of cancelled cheques when no receipts have been taken.

When the loan is being examined the overdue items should be listed, the list showing loan number, borrower, location of property, amount of loan, rate, date paid to, and amount overdue.

When no register is used the items must be checked directly to the cash book.

Occasionally endorsements will be found that are not entered upon the register and entries upon the register or cash

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book not endorsed upon the notes. Such errors should be brought to the attention of the proper official of the bank and the record completed before the loan is released.

It will be understood that an examination of the mortgage loan is not complete unless the items are verified by correspondence with the borrowers, but this rarely is done by the accountant.

In Massachusetts the bank commissioner's department during the years 1911 and 1912 verified all of the outstanding mortgage loans held by the savings banks of that state, and the commissioner reported that surprisingly few differences were found to exist. In Massachusetts the mortgaged properties are required to be revalued every five years, but this the accountant need not follow.

The mortgage deeds should be examined, the transfer of title to the bank should be in proper form and the instrument should bear the endorsement of the registry of deeds showing that the mortgage has been duly recorded. Any deeds for recent loans which may not be on file should be proven by correspondence or by visiting the registry.

Insurance policies should be examined to see that the assignment to the bank is in order and that the total amount of insurance on any one loan is at least as great as the amount of the loan, and of those items whereon the insurance may appear short inquiry should be made as to whether or not the bank is protected. It may be that the greater value is upon the land covered by the mortgage. The examination of mortgage deeds and insurance policies may be made by the auditing committee, but where this is done that committee must report the result of the examination and the accountant should note this fact in his report.

The personal loan is divided into several classes as shown by the foregoing statement of condition.

The notes should be listed for proof of total in the same manner as detailed for the mortgage loan, and after the total has been agreed with the statement, the notes may be checked against the loan register and the transactions followed through to the cash book. The collateral deposited against loans should be examined and checked against the collateral record and listed for future reference. Whether or not the accountant is to prove the value

of the collateral should be decided by the auditing committee. The collateral should be verified by correspondence. Where the loan is made to brokers some accountants visit the brokers' offices and verify the collateral, but it seems to me that the accountant should have in his possession a record signed by the depositors of collateral. Verification letters may take somewhat the following form which has been found to be satisfactory in our practice:

Corporations desiring to borrow from savings banks in Massachusetts are required to have their books audited by an accountant approved by the bank commissioner, and loans of

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this class must, of course, be supported by the report of the accountant of the corporation.

Another class of personal loan, and one which to my mind should not be permitted to be taken by savings banks, is what is ordinarily known as "three-name paper," that is, loans made to three or more individuals without further security than their credit standing. These loans should be verified by correspondence with the borrowers. In some banks it will be found that such loans are continued from year to year, and where so continued the accountant should call such loans to the attention of his committee that they may take such action as may seem necessary.

The bonds and stocks carried as investments should be examined and listed by the accountant. This list should show the title of the security; if a bond, its due date, the rate of interest, the par value and the book value against each item, with sufficient space to enter the market value against each item in case the committee desires the accountant to calculate such value as of the date of the examination. At the time of the examination of the securities the par value only may be secured, the book value to be procured from the records of the bank. This list should be checked to the investment register where one is carried, and all income from investments checked in accordance with the due dates shown by the listing; and where stocks are carried it is usually possible to check the dividends declared from broker's records which are easily procured.

All purchases and sales of securities should be followed through to the cash book and should be supported by vouchers from the brokers through whom the transactions were made. It is claimed by some that the numbers of the securities should be taken in the listing, but, excepting in a small bank, it is doubtful if it is worth while to spend the time necessary to copy hundreds of numbers which may not again be used.

Where securities are bought at a premium, such premium usually is charged directly to profit and loss and the security carried at par value, but where the securities are bought for less than par they are carried at the price paid. When the securities are sold the difference between the book value and the amount received is carried to the profit and loss account. This practice of writing off the entire premium has occasioned considerable

comment, some holding that the amount paid in excess of par value should be carried to a premium account, which should be amortized properly. There are some banks which carry a premium account. Where a premium account is carried the accountant must see that it is being reduced periodically along proper lines. In general, reducing the premium by dividing it by the number of interest periods which it has to run and charging this installment off at every half yearly closing is well enough—is a simple method and much more readily understood than scientific amortization.

If the bank holds any securities taken for indebtedness, these, of course, will be examined and listed and the income therefrom proven in the same manner as for regular securities.

A separate account should be carried with each parcel of real estate by foreclosure and in possession. The deeds and other documents relating to the transfer or buying in of such estates should be examined carefully to see that the title properly is vested in the bank. All expenses of maintenance, taxes and insurance should be supported by proper vouchers and if the properties produce income, this should be verified and checked into the accounts. Usually the expenses and income on such properties are carried through the cash book to the profit and loss account, but in some instances the items are carried to a general account of "expenses and income on foreclosed property" which is afterward closed out to profit and loss account. The assessed value of the estates held under foreclosure should be ascertained and listed by the accountant for his report.

All charges for maintenance, etc. of bank building should be supported by proper vouchers and if any portion of the building is rented the income from such rental should be verified. These transactions are often covered into an account entitled "income and expenses, bank building," which is closed regularly to profit and loss account, or may be carried through the cash book directly to profit and loss. When there are safe deposit vaults connected with the bank the income from rent of boxes should be proven.

A regular charge should be made against the expense account for the bank's proportion of rent of the banking building, which amount will usually be determined by the executive committee of the bank. In nearly every instance the value of the bank

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building is carried upon the books at less than the assessed valuation of the property and the item of depreciation is rarely considered. In no case should income from the bank building be used to reduce the building account.

Furniture and fixtures will probably be carried at a very conservative valuation, if shown at all, but where such account is carried it should be seen that the value is reasonable and that depreciation is cared for.

The trial balance required shows "other assets," and if there are any items carried which may not fall under the regular classifications, they must be entered under this caption.

Occasionally some little study will be required to determine where to classify certain items which may be found among the assets of these banks. The writer remembers well an argument of the staff as to the classification of the assets of one bank. In examining the expense account we found a voucher for killing a black bear and for preparing the hide thereof for a rug for the private office of the bank. The assistant checking the expense account was willing to pass this voucher as an expense item, but immediately propounded the question as to the classification of the item had we arrived for the examination before the killing took place!

The expense account should be supported by satisfactory vouchers, and it is not customary to show any analysis of this account. The expenses run so evenly from period to period that any marked increase or decrease may readily be noted, and in such event if desired by the committee the accountant may analyze the account, separating it into such divisions as may be required for the purposes of the committee.

I have already given a sketch of the depositors' ledgers, and now come to the verification of practically the only liability of the bank.

The total amount due depositors will be shown by the controlling account in the general ledger, and this amount may be verified by drawing a trial balance of the individual accounts as of the date of the examination. In the larger banks where the system of control is satisfactory and the duties of the clerks are so arranged that proper internal check is carried, the drawing off of such a trial balance by the accountant or the checking of one already prepared by the staff of the bank is about all that is

usually done towards providing the amount due depositors. Some accountants check the trial balance as of the beginning of the period simultaneously with the checking of the balance at the close of the period, thus making certain that the balances agreed with the controlling account at both times.

It is seldom that the trial balance of the depositors' accounts will show the account numbers, and where card ledgers are used and the account numbers are not shown upon the trial balance tapes, a memorandum should be made of the missing numbers and they should appear in the closed account file.

In the examination of the smaller banks the use of the five-column trial balance has been found of service. The five-column sheet carries balance at the beginning of period, deposits, payments, dividends, and balance at the end of period; the totals of these columns agreeing with the totals shown by the general ledger, proving the accuracy of the work for the period.

Where such trial balances are prepared by the staff of the bank, the footings should, of course, be proven, even though the work has been done on the adding machine.

While the law contemplates but one deposit in a bank from a person and limits the amount of such deposit, it is not uncommon to find deposits taken of a larger amount than allowed, or one person with more than one account in a bank. This latter condition is not easy to follow since it is impossible to keep in mind the names of depositors, and it will not be noticed except where two or more accounts of the same name are posted side by side on the ledger, or on following cards. How far the accountant should go in reporting such occurrences must be determined by the facts of each case.

In Massachusetts the dividend is declared semi-annually, and according to law it is from income which has been earned and which has been collected during the six months next preceding the date of such dividend. Ordinary dividends are not to exceed two and one-half per cent on all amounts which have been on deposit for the six months last preceding, or one and one-fourth per cent on all amounts which have been on deposit for the three months last preceding. The dividend sheets should be checked to the individual accounts and the total reconciled with the amount charged against interest for the period, and where the law requires any amount to be set aside for guarantee or

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reserve fund before the payment of each dividend, it should be seen that this requirement has been complied with.

All charges to interest accounts should be carefully examined and properly established.

The receipts and payments having been checked from the subsidiary records to the cash book as shown in the foregoing pages, the footings of that book should be proven for the period and the balance agreed with that shown by the statement. Where the cash book is posted directly to the general ledger all such postings should be checked. Where the cash book entries are summarized in the journal the journal entries should be checked from the cash book, the footings proven and the summaries checked to the general ledger.

It should be seen that all postings in the general ledger have been checked and a trial balance should be drawn off, which, when summarized, should agree with the statement worked against during the examination. In addition to the general accounts with investments, the general ledger usually contains the detail of the securities, from which the book value of the items may be procured, and the total agreed with the statement.

The transactions in the profit and loss account during the period should be examined and proven and a detailed transcript of the account for the period under examination should be drawn off.

The minutes of the investment committee should be examined to see that all new loans, purchases or sales of securities have been passed upon by that committee.

In Massachusetts the accountant is required within ten days after the completion of the examination to deliver a report in duplicate to the auditing committee, one copy to be forwarded by the committee to the bank commissioner.

This report shows a trial balance of the general ledger as hereinbefore set forth, and the accountant is required to report how he has covered the various items upon the trial balance during his examination, including in the report a statement of all overdue interest and a transcript of the profit and loss account, with such other statements or memoranda as the case may seem to require. In general, the supplementary statements show a list of the stocks and bonds and other securities owned by the bank, exhibiting the par and book value, and in some

cases the market value; a list of the collateral loans with the collateral deposited against each loan; and a list of the "three name paper" or other personal loans showing the name of the borrower and sureties.

The programme, herein laid down should constitute a complete examination with the exception, of course, of the proving of the depositors' accounts, an absolute proof of which may only be had by calling in all the pass books or by correspondence with the depositors. It is only in exceptionable cases that this extreme measure is carried out.

The depositors' books are required by law to be verified every three years. Notice of the verification period is advertised in the daily papers, and many banks employ a temporary clerk whose sole duty it is to verify the pass books against the depositors' accounts.

In Massachusetts savings banks may undertake the business of life insurance, the object being to eliminate the agent and house to house collection of premiums of the old line industrial insurance system. These banks may establish agencies for the collection of premiums in mills, factories, or other places, or, if desired, employees may authorize the employer to deduct the amount of the premium from the pay roll and to pay the premium once a month to the bank, and if a policy holder has a savings account in the bank he may authorize the savings department to pay premiums from that account. Although this system was established under the acts of 1907, only four banks have undertaken the business of writing life insurance, and since the departure is practically a small one and is not to be found outside of Massachusetts, it is not considered worth while here to enter into any programme, for the audit of the insurance department.

Accounting and Auditing as Related to Credits

BY H. IVOR THOMAS, C. P. A.

Before taking up the relationship of accounting and auditing to credits it will be well to review briefly the nature of credit, its scope and requirements, to determine what features should be provided for in a credit accounting system. In the early days of barter and exchange trades were made by interchange of commodities, and theoretically this is true to a certain extent with regard to international commerce, where the difference in amount of commodities interchanged is known as the balance of trade. The growth of trade gradually made it impossible to adjust balances in products and commodities, and another medium of value had to be developed. Money came into use. With the growth of transactions between individuals, families, tribes, these conditions appeared: dwellers in one section required products dealt in by neighbors some months earlier than they themselves might be able to make delivery of commodities they wished to exchange, and in the absence of cash resources they were obliged to obtain what they needed on the strength of an agreement to deliver an equivalent value at a future date. Thus credit grew.

In these days of large business, more particularly in the wholesale trade, only a small proportion of sales is for cash; in fact nearly all wholesale business is conducted on credit, and in order to make business secure and to guard against losses by advancing credit to firms or persons who may fail to keep their promise it is necessary to establish credit ratings for buyers in order to guard against such loss.

The proper collection and allocation of the information necessary to establish credit rating is of sufficient importance to the wholesale house to justify the creation of a department, the business of which is to gather details of credit information concerning its customers; and upon this department, or its head, rests the responsibility of deciding what credit, if any, shall be advanced to new customers, or what steps shall be taken to shorten a previous line of credit.

Before referring to the nature of the information required

and the means of obtaining it, I would refer to the chief methods of making sales by the wholesaler. The method usually used is through traveling salesmen who periodically visit the retail traders in their assigned territory. The less generally employed method is through the use of the mail service, in which case the wholesaler depends upon catalogues or other advertising media to obtain orders. The advantages of selling through salesmen are that the purchaser comes into closer personal touch with the buyer, thus often securing an order when other conditions are equal; that is, if prices, terms and quality of goods offered by two houses are practically the same, the order may be given to the house which has established a personal connection. A salesman can in many instances get information regarding a customer's credit and general standing in the community that will be of value to the credit manager. He may be instrumental in selling a larger bill of goods than the retailer would buy if ordering from a catalogue, because he is trained by coming into contact with a large number of houses to estimate the probable needs in a district with more certainty of success than the retailer himself.

On the other hand, selling goods by mail has an advantage in that the wholesaler knows at all times what recommendation he is giving his goods and what representations he is making to his customers, whereas he cannot always be sure of the arguments put forward by his representatives. Another advantage is that he does not run the risk, that sometimes occurs, of losing customers when a salesman severs his connection with one house and is able to carry with him a number of his trade.

There are two main methods of investigating the credit standing of a proposed buyer, the direct or personal method, which involves an interview with the buyer in which the credit man should be able to form a reliable estimate of the personality of his proposed customer, and in the course of which he can ascertain through questions facts which it is most essential he should know; and, when he has also an opportunity to examine the books. In commercial credits, no less than in the granting of credit by a bank, the element of personality is of vital importance. Occasions occur during times of extraordinary financial stress, when collections will be below normal, and at such times credits may be extended with greater security to those

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buyers known to be personally reliable. Where a personal interview is not possible, the credit man will call for a statement of his proposed customer's financial standing; and though such a statement is not always accepted as conclusive proof, it is valuable if proper weight be given to its important features, which are herein referred to.

It is becoming more and more the custom to require such a statement to be signed by a responsible member of the firm to secure the most reliable information that may be obtained in this manner, as it brings the statement within the scope of the "False Statements in Writing" laws. Even so, a statement prepared in good faith may not contain all the elements necessary to a true statement of condition, and greater protection can be secured by requiring a statement certified by a professional auditor.

The second is the indirect method, consisting in gathering information through a third party representing the credit man. This may be done by the traveling salesman, subject, however, to some drawbacks, chiefly the fact that the main interest of the salesman is at variance with that of the credit man; the salesman's first aim being to obtain an order without reference to the amount of credit that it is safe to allow his customer. Many large firms employ an experienced man to obtain information of this character in person, but such method is too expensive to be used except in the case of large firms. The large body of wholesalers rely for this information on the reports furnished by a commercial agency reporting company; but this business is now almost entirely in the hands of two concerns, Dunn's and Bradstreet's, each of which has been in existence upward of 60 years. Some complaints have been made with regard to agency reports, notably that their information lacks details and requires additional verification from other sources.

One of the causes of this incompleteness seems to be due to a lack of willingness on the part of the smaller traders to furnish as complete information as the agencies desire. There is, however, a growing tendency to overcome this defect, for merchants are learning that they cannot expect to receive full and complete information of the business-standing of others unless they are willing to give similar information concerning themselves.

To pass to a consideration of items that should be known in order to establish a credit rating, and the method of their acquisition: I would refer to the reports which have been endorsed by the National Association of credit men (where the arrangement differs to some extent from the usual accountant's report), as being most applicable to the purposes for which it is to be used. The fundamental principles of this form of report are the requirement of a complete segregation between business assets and outside assets: the object being to show clearly under the head of business assets all those values which are readily available, to distinguish them from those which could not be readily converted to the extinction of the debt. Another valuable feature of these reports is that they call for the net value of accounts and notes.

The accounting features necessary in a credit department refer to the systematic classification of the reports and the information obtained from them, and their arrangement in such a way that quick reference may be made to any particular case. A good plan for use in this connection is to make use of cards of different colors, for example white, blue and red, to be used in the following way: Record all information of normal cases on white cards; whenever it has been found necessary to refuse credit to a customer transfer his record to a blue card, and always in future keep such a record on the card to which it has been transferred as a reminder at a glance that there was once some trouble in this particular case. Then the red card may be used as a special sign of danger in those accounts where it has been necessary to place the account in the hands of an attorney for collection.

A valuable statement for use in a credit department is one that shows creditors' accounts segregated into columns distinguishing between accounts not due and those over-due for varying periods of time, that is, one column may be used for accounts which are three months overdue, another, for those six months overdue and so on, such statements may be prepared as frequently as the needs of the business require.

The credit department will obtain better results and with less friction if the customers' accounts are carried on a card system rather than in bound books because it will be easier to refer to individual accounts on them, than to require a large book

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to be submitted for inspection whenever it is desired to look over a customer's account. A useful card to be furnished to salesmen is one upon which they can report such information concerning a new customer as they are able to obtain without being obliged to ask questions that would injure the chance of making a sale; and such information can be advantageously renewed by them from time to time in the case of old customers. This information should cover such items as the following: General condition of the business; general appearance of the store; condition of stock; what amount of advertising is used; are the clerks courteous and obliging; is the proprietor a good business man, and how is he regarded in his town? These are a few of the questions that might be inserted on the card, and are given as a guide.

The important feature of the credit business is that of collections. While the retail merchant cannot always insist upon the same promptness of payment of accounts as can the wholesale house the latter should insist upon prompt payment. Whenever a delay occurs in the payment of an account it should be followed up systematically, and wherever possible before resorting to extreme measures a personal visit should be made to the purchaser in order to find out all the conditions, for such a course will sometimes disclose facts that will make it advisable to extend the credit beyond the normal time, and thus save the account. The ideal arrangement with regard to collections is to have them under the direct supervision of the credit department, as the functions of these two branches of the business are so closely connected that the best results may be obtained from this arrangement.

We have referred to the connection between accounting and credits, and will pass to the relation between auditing and credits. The difference between accounting and auditing is: accounting relates to the recording of facts of commercial transactions in the books of account; auditing refers to the correct reading of what the books of account relate. The important requisite of the credit man is the ability to not only analyze correctly a statement rendered to him but, also, to read accurately information furnished by an examination of a customer's books. In other words he should be able to audit a set of books and obtain the correct interpretation. Without such a knowledge he is in

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danger of being misled if the report or statement be incorrectly prepared, and would probably fail to detect weak or unstable conditions which would be evident to an auditor.

While a great deal has been accomplished in some cities by associations of individual trades formed for the purpose of exchanging credit information through a species of clearing house, there is still room for development of this kind of activity. The majority of associations of this nature furnish their members or subscribers information of great assistance in the matter of extending credit; but they usually insist upon evading the responsibility for adverse reports, by concealing the names of those who furnished the reports from the other members.

On the other hand, there is, for instance, in existence in Los Angeles an association dealing in building materials, which by a key system discloses to the members the source of information, and its members claim that this plan has been productive of excellent results, both in demanding publicity with regard to the former conduct on the part of the applicant for credit, and in the collection of old accounts. It would seem that this principle of publicity might well be extended so as to embrace associations covering other lines of business.

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EDITORIAL

A Question of Solicitation

In a recent issue of *The Canadian Chartered Accountant*, the official organ of the Dominion Association of Chartered Accountants, attention was drawn to the fact that certain newcomers in accountancy in Canada had been guilty of soliciting work among the clients of other accountants.

The matter was mentioned also in *The Accountant*, London, and astonishment was expressed that any reputable accountant should lend himself to a practice which is universally condemned by the profession.

We are glad to see that our contemporaries in Canada and Great Britain are alive to the iniquity of the practice which unfortunately does prevail in some localities. It is absolutely unpardonable for any accountant to endeavor to intervene between practitioner and client. We go even further and say that solicitation of any kind should not be countenanced; and we believe that

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in the not distant future the accountant who is guilty of such a breach of ethics will be severely disciplined by the associations governing the profession not only in America but also in other parts of the world.

Our greatly esteemed contemporary *The Accountant*, however, seems to us to have conceived a wrong idea of conditions. We quote the following from an editorial on the subject.

In the third place, while we can quite understand how someone altogether ignorant of American conditions might easily make the mistake of supposing that what is regarded as legitimate in the States is regarded as equally legitimate in Canada, the offences of which our contemporary complains are obviously such as would not be condoned by any professional body, no matter where situated. This is not merely (if the facts are correctly stated) a matter of distinguishing between refinements of American and Canadian practice, but something which should be repugnant to the good feelings of all right-minded practitioners; something which the representatives of high-class firms ought never to descend to, even if it were to be sanctioned by local custom.

We should be loath to believe that accountants in Canada or in Great Britain entertain an inferior conception of the ethical standards which should be maintained. We are confident that the "refinements" of the profession are as high in the British dominions as in the United States. Of course there are unworthy members of the accounting profession in every country exactly as there are unworthy members of all the other learned professions, but it seems to us most unfortunate that a representative organ of accountancy should imagine for a moment that the standards differ in different English-speaking countries.

While we have no wish to indulge in comparisons, however, we are impelled to the thought that possibly our contemporary may have judged a large portion of the profession by the actions of a small minority.

There has been solicitation of business in Great Britain and in the United States, and if we were to enter into an argument of comparative nationalities it might lead to unfortunate and acrimonious discussion. But this we have no intention of doing. Accountancy owes an infinite debt to the fathers of the profession in Great Britain; and in America especially we have always been ready to admit the obligation. For this reason there has been a readiness to overlook the practices of certain British accountants in America because it has been realized that they are

no more representative of the profession in the land of their birth than of the profession in the land of their adoption.

Extraordinary, But is it Unreasonable?

It required just such a man as that Detroit automobile manufacturer—with more millions of idle cash worrying the hearts of Detroit bankers than the owner of them knows what to do with—to step suddenly into the limelight of the world and defy the economic formulae of the ages.

This man has more than the accumulation of dollars to back him in what must for some time be looked upon as an experiment. He has had convincing experience in business; he has acquired the wisdom of pleasant association with employes; he has reaped the rewards of the highly-skilled mechanician; and he has somewhat solved the problem of making one machine do the work of many men without disturbing the nervous system of human labor. He seeks broader results by means of higher wage, shorter hours, money bonuses, and the sociological uplift of those who assist him in the making of more millions.

The natural instinct of the public has been to criticize the wisdom of the act, if not to question its sanity. It was so sudden, so different from what the average man would do. Why jeopardize such a vast property, why invite ruin? Will he ultimately be looked upon as the one to prove himself a defier of the laws of supply and demand, (classifying labor as a commodity), and can he meet the requirements of "artificial interruption," such as may grow out of legislative restrictions or the demands of trades unions?

Whether or not industrial conditions have been so revolutionized as to fortify the position taken by this Detroit manufacturer, remains to be seen. There are those who pass over the sociology and the political economy of the situation, and who hold that the chief result may be the securing of a broadly better class of skilled workmen, and that therefore there will be a correspondingly greater and better output of finished material. Higher wages and profit sharing should work to this advantage.

The man who is now so prominent before the economic

world bluntly declares himself "no philanthropist"; and is a "believer in the gospel of goodwill." He cannot look upon his army of workmen "as chattels" because they make profits for him. On the contrary they are "commercial assets" upon whom he must absolutely depend. And his purpose is "to keep this army of men contented, prosperous and faithful."

Here is bared the business quality of one of the largest individual employers of labor in the United States. All is so different from the usual relations between manufacturer, workman and consumer that it is not to be wondered at that it is looked upon as almost unbelievable.

Mexico's Moratorium

President Huerta's decree of a moratorium of one year's duration is a rather new thing among the governments of the larger class in Latin America. Some of the smaller states have had defaulting records that are not entirely enviable, but the bigger ones have been fairly faithful in meeting the annual charges on their external debts. Yet it is not generally known that one of the South American states, within the past six months, gave the option to a foreign banking-house, which usually floated its loans, of either floating another at a particularly inopportune time or of having a moratorium declared covering a period of three years.

Whether that would have been done, or not, is a question. But falling prices often have the same effect on government finances as a prolonged civil war.

Income Tax Department

EDITED BY JOHN B. NIVEN, C.P.A.

A further instalment of Treasury Department Rulings in connection with the Income Tax Act is published this month. As these rulings include the forms for making the return of income to the government it may be assumed that the administrative part of the regulations is now fully disclosed. The matter presented is as follows:

Ruling 1920, permits the use of the ordinary or usual business signature of owners of bonds, etc. or their duly authorized agents on certificates of ownership, and this permission is extended to certificates heretofore executed. The point of this ruling is that full christian names need not be signed.

Ruling 1922, exempts from deduction of the tax at the source certain municipal district or local bonds and other obligations. This modifies, as to deduction at the source only, ruling 1910, heretofore issued.

Ruling 1923, deals with a provision of the act which has been the occasion of much controversy, *vis.*: The proper application of the statutory exemption from net income for purposes of calculating the tax, of \$4,000 of the income of married persons. The regulation formerly given, and now superseded, did not clearly define the position of the treasury department and this ruling has been issued to remedy the defect, and though it may not remove all the grounds of argument it certainly seems clearly to state the department's position under all contingencies.

The ruling extends to each of the spouses the exemption of \$3,000 in cases where the husband and wife are separated and living permanently apart; but where they are living together the department takes the position that the husband and wife are entitled to one single exemption (amounting to \$4,000) from the aggregate net income of both, and no more. The single or married status of a person is to be determined as of the time of claiming the specific exemption, if within the year of taxation, or otherwise the status at the close of the year.

Returns are required in every case where either the husband or wife separately has an income equal to or in excess of \$3,000, even though the combined income of husband and wife be less than \$4,000, and returns are likewise required in cases where the aggregate income exceeds \$4,000 although neither husband nor wife separately has an income of \$3,000.

The ruling also specifies that either spouse may make his or her return separately or may make one return for the joint incomes—advising, however, in event of two returns being made, that they be forwarded to the collector together. The ruling then proceeds to state that if the combined income exceed \$4,000 the spouses are jointly and separately liable for the return of the combined income and that they are also jointly and separately liable for the payment of the tax. If this latter provision is within the act, it might in certain circumstances impose an

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obligation upon one spouse which he or she, no matter how anxious to do so, might be unable to meet.

Ruling 1926, allows the text of certain forms used by nonresident foreigners to be printed in a foreign language directly under each line of the English text.

Ruling 1927, extended to January 20, 1914, the time for filing certain monthly list returns.

Ruling 1928, gives the official number of forms which have been prescribed by the department for the purposes therein described. Included among the forms prescribed are those for making return of net income for the purpose of having the tax assessed and these have been divided into eight distinctive forms—Nos. 1030 to 1035 inclusive, for various kinds of corporations; No. 1040 for individuals or their duly authorized agents; and No. 1041 for fiduciaries. As they will be constantly referred to in the future, these forms, together with the instructions appended to each of them, are also published in this number of *THE JOURNAL OF ACCOUNTANCY* in reduced facsimile and reference is made to them for full details.

Ruling 1929, gives a form to be used where a collecting agent's certificate is substituted for that of the owners when the owners are fiduciaries not claiming exemption at the source.

Ruling 1932, contains only instructions relative to the duties of income tax agents and inspectors in administering the act and therefore does not so directly concern the general public; but it is also published here as it may be interesting for individuals and corporation officials, etc. to know what general authority is given to such agents and inspectors with reference to the investigation and scrutiny of the returns and examination of the private records of taxpayers.

Ruling 1933, gives a ruling on the position of mutual telephone companies and like organizations under the Law.

Ruling 1934, holds that individuals whose net income is \$2,500 or more for the ten months ending December 31st, 1913 must make a return for that period.

Ruling 1936. Under this heading the department publishes the decision of court in a case under the corporation tax act and, as a matter of record on account of the points raised in the decision, there has been published along with the rulings in this number of *THE JOURNAL*, the rubric of the ruling and a summary of the case. The decision is too voluminous to print in full.

TREASURY RULINGS

(T. D. 1920 December 20, 1913)

Certificates of ownership heretofore executed, or which may hereafter be executed, by the owners of bonds, etc., or their duly authorized agents, need not be signed with the full christian name of the owner or agent, but the said owner or agent may use his ordinary or usual business signature.

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Certificates of ownership, heretofore executed by the owners of bonds, etc., or their duly authorized agents, in compliance with the income-tax regulations, and signed either with the christian name or the ordinary or usual business signature, and giving the full address of the owner, shall be accepted by debtor organizations or their duly authorized withholding agents.

Hereafter it will not be required that ownership certificates be signed with the full Christian names of the owners by the owners or their duly authorized agents, but the said owners or agents may use their ordinary or usual business signatures, provided it identifies them and is accompanied by their complete address.

(T. D. 1922 December 24, 1913)

Collection at the source of income tax from certain municipal district or local bonds and other obligations.

Until January 15, 1914, and thereafter until further instructions are issued, the income derived in the shape of interest from the obligations, general or special, of any state, or of any county, municipality, or taxing district therein, shall be exempt from the collection of the income tax at the source, whether the payment of such obligation is provided for by general or local taxation or out of a general, special, or separate fund.

Any regulation or ruling of the Bureau of Internal Revenue in conflict herewith is hereby suspended as above provided.

(T. D. 1923 December 27, 1913)

Regulations regarding the specific deduction provided for under paragraph C of the provisions of section E of the income-tax law of October 3, 1913, relative to the returns of husband and wife.

Every single person and every married person not living with husband or wife in the sense below defined who has a net income exceeding \$3,000 per annum is liable to pay the normal income tax under this law, but in making return for such tax may claim an exemption of \$3,000 from their total net income.

Husband and wife living together are entitled to an exemption of \$4,000 only from the aggregate net income of both, which may be deducted in making the return of such aggregate income for taxation. However, when the husband and wife are separated and living permanently apart from each other each shall be entitled to the exemption of \$3,000.

If the husband and wife not living apart have separate estates, the income from both may be made on one return, but the amount of

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income of each and the full name and address of both must be shown in such return.

The husband, as the head and legal representative of the household and general custodian of its income, should make and render the return of the aggregate income of himself and wife, and for the purpose of levying the income tax it is assumed that he can ascertain the total amount of said income.

If a wife has a separate estate managed by herself as her own separate property and receives an income of more than \$3,000, she may make return of her own income, and if the husband has other net income, making the aggregate of both incomes more than \$4,000, the wife's return should be attached to the return of her husband, or his income should be included in her return, in order that a deduction of \$4,000 may be made from the aggregate of both incomes. The tax in such case, however, will be imposed only upon so much of the aggregate income of both as shall exceed \$4,000.

If either husband or wife separately has an income equal to or in excess of \$3,000, a return of annual net income is required under the law, and such return must include the income of both, and in such case the return must be made even though the combined income of both be less than \$4,000.

If the aggregate net income of both exceeds \$4,000, an annual return of their combined incomes must be made in the manner stated, although neither one separately has an income of \$3,000 per annum. They are jointly and separately liable for such return and for the payment of the tax.

The single or married status of the person claiming the specific exemption shall be determined as of the time of claiming such exemption if such claim be made within the year for which return is made otherwise the status at the close of the year.

These regulations hereby supersede the regulations relative to paragraph C of the income-tax law, as prescribed on page 4 of Regulations, part 2, issued under date of October 31, 1913.

(T. D. 1926 December 30, 1913)

Regulations permitting text of certificates of ownership, 1004, 1014 and 1016, used by nonresident foreign individuals, partnerships, and organizations, to be printed in foreign language directly under the English text of said certificates.

Certificates of ownership required to be filed with interest coupons or orders for registered interest by nonresident foreigners on form 1004, by foreign partnerships on form 1014, and by foreign organizations on form 1016 shall be printed, as prescribed by regulations, in the English language, and directly under each line of the English text on each of the above-mentioned certificates there may be printed the text of said certificate in a foreign language.

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In executing these certificates, however, all blanks to be filled in, with amounts, shall be filled in, using United States dollar values.

These certificates shall be of the same size as prescribed by regulations for all certificates of ownership.

(T. D. 1927 January 2, 1914)

Extension of time for filing monthly list returns by the first bank or collection agency receiving coupons or interest orders for collection, when not accompanied by a certificate of ownership, and monthly list return required to be filed by licensed bank or collection agency collecting income from bonds, etc., issued in a foreign country, in accordance with the requirements of section 2, act of October 3, 1913 (T. D. 1887).

The time for filing the (a) monthly list return required of the first bank or collection agency accepting coupons or interest orders for collection, when not accompanied by a certificate of ownership, and the (b) monthly list return required of licensed banks or collection agencies collecting incomes from bonds, etc., issued in a foreign country, as provided in T. D. 1887 (pp. 5 and 6), which are required to be filed on the 20th day of the month next succeeding that in which said items were received, is hereby extended to January 20, 1914.

(T. D. 1928 January 2, 1914)

Regulation prescribing additional forms on which to make returns of annual net income for the income tax.

The forms numbered and described below, in addition to those previously approved, are prescribed by this department for the purposes indicated in connection with the administration of the Federal income-tax law (sec. 2 of the act of Oct. 3, 1913):

Forms 1030, 1031, 1032, 1033, 1034, and 1035 are to be used by corporations in making their returns of annual net income, as follows: No. 1030 by insurance companies; No. 1031 by banks and other financial institutions (class A); No. 1032 by public service corporations (class B); No. 1033 by manufacturing corporations (class C); No. 1034 by mercantile corporations (class D); No. 1035 by miscellaneous corporations (class E).

Form 1040 is to be used by individuals, or their duly authorized agents, in making the personal return of annual net income.

Form 1041 is to be used by fiduciaries in making returns of annual net income in behalf of their beneficiaries and as withholding agents.

Form 1042 is the annual list return of withholding agents of taxes withheld by them on income other than that derived from corporate obligations.

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Form 1043 is a monthly list return of taxes withheld on foreign income by licensed banks or collecting agents.

Form 1043a is the annual list return to be made by licensed banks and collecting agents of taxes withheld by them during the year on foreign items.

Form 1044 is a monthly list return of taxes withheld by the first bank or collecting agency receiving coupons or interest orders not accompanied by certificates of owners.

Form 1044a is the annual list return of taxes withheld during the year by the first bank or collecting agency receiving coupons or interest orders not accompanied by certificates of owners.

Form 23a will be used by collectors in listing, for assessment, the corporations showing net income upon which the tax is to be computed, this form to be prepared in duplicate.

Form 23b will be used by collectors in listing, for assessment, withholding agents, fiduciaries, etc., and individuals who return a taxable income.

(T. D. 1929 January 3, 1914)

Supplemental regulations prescribing form of certificate to be attached to interest coupons in cases where the collecting agent's certificate is substituted for the certificate of the owners, when said owners are fiduciaries not claiming exemption at source.

Subject to the provisions of the regulations in T. D. 1903, dated November 28, 1913, collecting agents may substitute form 1019a, properly filled in and numbered, for the certificate of the owner on form 1019.

When collecting agents substitute their own certificate in lieu of owner's certificate on form 1019, said substitute certificate shall be in substantially the following form:

(FORM 1019a)

Form of certificate to be attached to interest coupons in cases where the collecting agent's certificate is substituted for the certificate of the owners.

(When owners are fiduciaries)

(The owner's certificate, of which the following certificate is the counterpart, and bears the same number as this certificate, will be sent by the collecting agent direct to the Commissioner of Internal Revenue at Washington, as prescribed by regulations.)

No.....

I (we).....(Name of collecting agent), do solemnly declare that the owner of \$..... bonds of the(Name of debtor organization), from which were detached the accompanying interest coupons due(Maturity), 191..., amounting to \$..., has filed with me (us) a duly

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executed certificate filled up in accordance with Treasury Regulations of December 8, 1913, *Form No. 1019*, which certificate has been indorsed by me (us) as follows: "Owner's certificate No. (Name of collecting agency), (Date, 191....," that said certificate is executed by a fiduciary, and that the fiduciary, acting for and in the capacity as stated therein, did not claim any exemption from having the normal tax of 1 per cent withheld from said income by the debtor at the source; and I (we) do hereby promise and pledge myself (ourselves) to forward the above-described certificate executed by the owners as stated and dated....., 191...., to the Commissioner of Internal Revenue, at Washington, D. C., not later than the 20th day of next month, in accordance with Treasury Regulations.

Signature of collecting agent:

Date:, 191.... Address:

(T. D. 1932 January 13, 1914.)

Instructions relative to assignment to duty of income-tax appointees.

Revenue agents in charge of revenue agents' divisions and income-tax revenue agents and inspectors are hereby instructed as follows:

1. Income-tax agents and inspectors appointed under the provisions of the act of October 3, 1913, and paid from the appropriation for collecting the income tax will be assigned to duty under the supervision of agents in charge of revenue agents' divisions.

2. Persons appointed either as income-tax agents or income-tax inspectors, when the appointment is sent from this office, will be instructed by letter to report to one of the division revenue agents for duty, and until otherwise ordered may report either in person or by letter, and if by letter await the instructions of the agent in charge of the division to which they are assigned.

3. Officers of this class are expected to perform the duties of their offices where their services are required, but for the present, and until they become somewhat familiar with the duties of their places, they will be assigned to the revenue agent in charge of the division embracing their legal residence.

4. Income-tax agents and inspectors will be expected to confine their operations to income-tax work so long as there is income-tax work to be performed, and division agents are admonished not to employ officers of this class for the general or ordinary work of the bureau except when their services are not required on income-tax work.

5. The duties of officers of this class are to ascertain and report the names of persons who in their opinion are liable to the income tax and who have failed to make return as required by law; to inquire into income-tax returns where there is any suspicion that the return made is erroneous; to examine the books and accounts of persons who have made returns for the purpose of ascertaining and reporting as to whether the law has been complied with, when so ordered by the agent in charge of the division to which they are assigned; to inquire into the manner in which income-tax employees are discharging their official duties and to report those

The Journal of Accountancy

who have failed in this respect. For the purpose of securing such information as they may desire they may visit the office of any state, county, or municipal officer, and for the general purpose of their employment may confer with any collector or deputy collector of internal revenue within the territory in which they are authorized to operate.

6. The reports of these officers should be made to the agent in charge of the division to which they are assigned, who in turn will report to the Commissioner of Internal Revenue and the collector of the proper district.

7. In the discharge of their official duties officers of this class, as well as all officers of the Internal-Revenue Bureau in making inquiries and investigations are expected to exercise sound discretion, treat all persons with due courtesy, and, while acting firmly and courageously, to avoid all contention or controversy that would give just ground for complaint.

(T. D. 1933 January 12, 1914)

Mutual telephone companies, mutual insurance companies, and like organizations whose status, under the law, is not dependent upon whether or not they are organized for profit, and not being specifically enumerated as exempt, must make returns of annual net income pursuant to the requirements of section 2, act of October 3, 1913.

Letter to Collector of Internal Revenue, Omaha, Neb.

This office is in receipt of your letter of the 31st ultimo, asking advice as to whether or not mutual telephone companies will be required to file returns of annual net income under the provisions of section 2, act of October 3, 1913.

In reply you are informed that under the provisions of the act above cited, every corporation, joint-stock company, and every insurance company, no matter how created or organized, is subject to the income tax and will be required to make returns of annual net income, except such as are specifically enumerated in the act as exempt from its provisions. In the list of those so enumerated as exempt do not appear mutual telephone companies or similar organizations.

Since under this act no exemption is provided, either express or implied, for mutual telephone and like companies, and liability is not dependent upon whether or not the corporation is organized for profit, it is held that all corporations not specifically enumerated as exempt will be required to make returns of annual net income and to pay any tax that may be assessed upon the net income returned.

This ruling will comprehend all telephone companies, local insurance companies, and like corporations whether or not they are organized primarily for the mutual benefit of their members.

(T. D. 1934 January 16, 1914)

Individuals whose net income from March 1 to December 31, 1913, both

Income Tax Department

dates inclusive, is \$2,500 or more must make returns of annual net income for 1913.

Section 2, act of October 3, 1913, provides that on or before the *1st day of March, 1914*, and the 1st day of March in each year thereafter, a true and accurate return, under oath or affirmation, shall be made to the collector of internal revenue by each person of lawful age who may be subject to the tax imposed by this section who has a net income of \$3,000 or over for the *taxable year*.

It is further provided that for the year ending December 31, 1913, the tax shall be computed on the net income accruing from March 1 to December 31, 1913, both dates inclusive, after deducting five-sixths only of the specific exemption and deductions allowable for an entire taxable year.

Since the return of annual net income for the year 1913, as applied to individuals, is for but *five-sixths* of the calendar year, and as the law provides that returns shall be made on the basis of *five-sixths* of the year, it is held that individuals whose net income is \$2,500 or more for the 10 months constituting the taxable period of 1913 shall make returns of annual net income in accordance with the general provisions of the law covering the 1913 taxable period.

(T. D. 1936 January 20, 1914)

Special excise tax on corporations—Decision of court.

1. TAXES DUE FROM STOCKHOLDERS.

The State tax on capital stock of banks under the Massachusetts statute falls directly on the stockholders, and these taxes can not be legally deducted from gross income in returns made by banks under the corporation tax act. The tax is not upon the banks, and in paying it they act as agents. T. D. 1763 sustained.

2. RETURNS.

The Commissioner of Internal Revenue, upon evidence produced before him, is authorized to amend incorrect returns, or make a return, as the case may be.

3. ASSESSMENTS.

The Commissioner of Internal Revenue is authorized to make additional assessments after the taxes have been assessed and paid on the original returns, even though the errors in the original returns were made without any intention to deceive or mislead.

4. THE THREE YEARS' LIMITATION.

The statute does not require the additional assessment to be made within the three years' period. The limitation is upon the discovery of error by the commissioner of internal revenue within three years.

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The foregoing rubric is followed in the official publication under this ruling by an extended report of the case of Eliot National bank vs. James D. Gill, Collector before the United States District Court for the District of Massachusetts, Dec. 29, 1913, but it has not been considered necessary to print the same here in full. The following summary is, however, presented:

In this case the plaintiff seeks to recover certain sums which represent certain taxes paid by the plaintiff for the years 1909, 1910, and 1911, under the provisions of the corporation-tax law of August 5, 1909.

The plaintiff is a national bank, located and doing business in the city of Boston. On May 1, 1909, and on April 1, 1910 and 1911, the shares of the capital stock of the bank were assessed by the city of Boston, under the provisions of revised laws of Massachusetts.

Returns were made by the plaintiff to the collector of internal revenue for the three years in question for the assessment of the corporation tax, and taxes based upon such returns were levied and paid. On or before February 27, 1913, the commissioner of internal revenue discovered that in making these returns the bank had deducted from its gross income the amount of taxes paid by it each year to the city of Boston. Thereupon the commissioner, having made or caused to be made an amended return, assessed an additional tax for each year upon the amounts so deducted, which additional taxes the bank paid under protest. This suit was brought to recover the sums so paid.

The decision of the court on the points raised is indicated in the rubric.

Income Tax Department

TO BE FILLED IN BY COLLECTOR.

Form 1000.

TO BE FILLED IN BY INTERNAL REVENUE BUREAU.

List No. _____ Class _____
District of _____
Date received _____ 1917

TIME PENALTY
FOR FAILURE TO HAVE THIS RETURN IN THE HANDS OF THE
COLLECTOR OF INTERNAL REVENUE ON OR BEFORE MARCH 1
ON WHICH 60 DAYS AFTER THE CLOSE OF THE FISCAL
YEAR IS A FINE NOT EXCEEDING \$50.00.
THIS PENALTY DOES NOT APPLY TO RETURNS RECEIVED ON OTHER DATES.

Assessment List _____ 1917
Page _____ Line _____

UNITED STATES INTERNAL REVENUE.

RETURN OF ANNUAL NET INCOME. (Section 2, Act of Congress approved October 3, 1917.)

INSURANCE COMPANIES.

RETURN OF NET INCOME Received during the calendar (fiscal) year ended _____ 1917

by _____

the principal place of business of which is located at _____ (Street and No.)

City or Town of _____ in the State of _____

(The "year" as hereinafter used means the calendar year or fiscal year as the case may be.)

1. Total amount of paid-up capital stock outstanding, or, if no capital stock the capital employed in business, at close of the year above stated. (See Note 8 on reverse of this form) _____
2. Total amount of bonded and other indebtedness outstanding at close of year. (See Note 9) _____
3. Gross Income (see Note A, and instructions, paragraphs 10, 18, 21, 22, 23, 24, and 25) _____

DEDUCTIONS.

4. (a) Total amount of all the ordinary and necessary expenses of maintenance and operation of the business and properties of the corporation EXCLUSIVE OF DEPRECIATION PAYMENTS. (See Note 12) _____
- (b) All rentals or other payments required to be made as a condition to the continued use or possession of the property. (See Note 13 on reverse of this form) _____
5. (a) Total amount of losses sustained during the year not compensated by insurance or otherwise _____
- (b) Total amount of depreciation for the year. (See Note 15) _____
- (c) Total amount (other than dividends) paid within the year on policy and annuity contracts _____
- (d) Total amount of net addition required by law to be made within the year to reserve fund. (See Note 16) _____
- (e) Amount of premiums repaid to policy holders and interest paid thereon (applicable only to Mutual Marine Insurance companies) _____
6. (a) Total amount of interest accrued and paid within the year on any amount of bonded or other indebtedness not exceeding one-half of the sum of its interest-bearing indebtedness and its paid-up capital stock outstanding at the close of the year _____
- (b) Total amount of interest received upon obligations of a State or political subdivision thereof and upon the obligations of the United States or its possessions _____
7. (a) Total taxes paid during the year imposed under authority of the United States or any State or Territory thereof. (See Note 20) _____
- (b) Foreign taxes paid _____

TOTAL DEDUCTIONS _____

8. Net income on which tax at 1 per centum is calculated _____

State of _____ County of _____ TO WIT:

_____, President, and _____, Treasurer of

the _____ a corporation, whose return of annual net income is set forth above, being severally duly sworn, each for himself, depose and says that the foregoing report and the several items therein set forth are, to his best knowledge and belief, and from such information as he has been able to obtain, true and correct in each and every particular; that the amount of gross income therein set forth is the full amount of gross income, including interest upon obligations of a State or any political subdivision thereof, and upon the obligations of the United States or its possessions, without any deduction whatsoever, received from all sources by the said corporation during the year stated, and that the net income therein set forth is the full amount upon which the tax at 1 per centum is to be calculated and assessed, under the terms of the Federal Income Tax Law of October 3, 1917.

SWORN AND SUBSCRIBED to before me this _____

day of _____, 1917 _____ President.

SEAL OF OFFICER
YAMUO
AFFIDAVIT. _____
(Official capacity.) _____ Treasurer.

Item A.—Gross income of insurance companies shall consist of the total of the gross revenues derived from the operation and management of their business and properties, together with all amounts of income from other sources, including dividends on stock of other organizations, whether subject to this tax or not, premiums, interest, rentals, and all items of income resulting from appreciation or adjustment, and shown by entries upon the books during the year for which the return is made.

Mutual marine insurance companies may exclude from the gross premiums collected the "amounts paid for reinsurance," including the remainder in gross income.

Mutual fire insurance companies may deduct from gross income "any portion of the premiums deposited returned to their policyholders."

Life insurance companies may deduct from their gross income "such portion of any actual premium received from any individual policyholder as shall have been paid back or credited to such policyholder, or treated as an abatement of premium of such individual policyholder within the year." The amount thus excluded shall include only such dividends or premiums returned or applied as represent a portion of the actual premium received from any individual policyholder.

Item B.—The deductions authorized shall include all expenses incurred under the various heads acknowledged as liabilities by the corporation making the return and entered upon its books during the year.

Amounts of income expended in paying dividends on stock, preferred or common, or in making permanent improvements or betterments, etc., or in any way transferred to capital account are not proper deductions in ascertaining annual net income. Interest paid on mortgage indebtedness on real estate completed or used by a corporation may be deducted under item 6 if the interest is paid as rental or franchise charge, payment of which is required to be made as a condition to the continued use and possession of the property. The amount so paid and included in item 4 should be stated separately under item 4 (b). (See Note 12 on reverse of this form.)

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INSTRUCTIONS.

SPECIAL NOTICE.—THIS FORM, PROPERLY FILLED OUT AND EXECUTED, MUST BE IN THE HANDS OF THE COLLECTOR OF INTERNAL REVENUE FOR THE DISTRICT IN WHICH IS LOCATED THE PRINCIPAL BUSINESS OFFICE OF THE CORPORATION MAKING THE RETURN, ON OR BEFORE MARCH 1, IN CASE THE RETURN IS BASED ON THE CALENDAR YEAR, OR WITHIN 60 DAYS AFTER THE EXPIRATION OF THE FISCAL YEAR IN CASE THE RETURN IS MADE ON THAT BASIS.

FOR FAILURE TO COMPLY WITH THIS PROVISION OF THE LAW, THE AMOUNT OF THE ASSESSMENT IS INCREASED 50 PER CENT AND LIABILITY TO A SPECIFIC FINESSE IS INCURRED.

1. Return of annual net income of corporations should be made on forms prescribed by the Treasury Department and should be filed with the Collector of Internal Revenue of the district in which such corporations have their principal places of business.

2. Before transmitting such returns to the collector they must be verified by two officers of the corporation; that is, by two individuals, each holding a different official title, namely: the President, Vice President, or other principal officer, and its Treasurer or Assistant Treasurer, or Chief Financial Officer.

3. The affidavit of verification must be made before a Notary Public or some other officer qualified to administer oaths; and the seal of the attesting officer, if such officer is required by law to have a seal, must be impressed on the return in the space reserved for that purpose.

4. Under the provisions of the law, the return must be true and accurate in every respect and must disclose all the income arising, accruing, or received from all sources during the year for which the return is made.

5. If the return is based upon the business transacted during the calendar year, it should be filed with the collector on or before the first day of March next succeeding such calendar year. If it is made on the basis of business transacted during a fiscal year, or consecutive twelve months period other than the calendar year, duly designated in accordance with the law and the regulations, the return must be filed with the collector on or before the last day of the 60-day period next following the date designated as the close of the fiscal year.

6. In case of sickness or absence of an officer required to verify the return, the collector of the district is authorized to extend the time for filing such return not exceeding thirty days from the date when such return is otherwise due. Application for such extension must be made prior to the date when the return is due.

7. The principal place of business as used in the act and in these regulations is held to mean the place or office in which the books of account and other data to be used in preparing the return of annual net income are ordinarily kept.

8. Item No. 1 of the schedule on the reverse side of this form should not include unissued or treasury stock, but only such stock as has actually been issued and for which payment has been received, or in case no stock is issued, there should be reported under this item the amount of capital actually employed in the business and property of the corporation.

In cases wherein the capital stock is issued payable in installments or upon assessment, only so much of the capital as has been actually paid in upon such installments or assessments should be reported under this item.

9. Item No. 2 should include all interest-bearing indebtedness for the payment of which the corporation or its property is bound. In case of banking corporations and like financial institutions, deposits should not be reported as indebtedness under this head.

10. Item No. 3 of the return form (gross income) should include all income derived from the operations and management of the business and properties, together with all actual increases in value by appreciation, adjustment, or otherwise in the value of the assets which have been taken up on the books as income or credited to profit and loss during the year. In the case of a corporation organized, authorized, or existing under the laws of any foreign country, the gross income to be returned is the gross amount of its income for the year, resulting from business transacted and capital invested within the United States.

11. Item No. 4(a) should include the total amount of all ordinary and necessary expenses paid out of earnings in the operation of the business and properties of the corporation, etc., exclusive of interest and other payments to be listed under their respective heads on the return form.

12. Item No. 4(b) should include all rentals or other payments required to be made as a condition to the continued use or possession of the property; that is to say, in case where interest on a mortgage on property occupied or used by the corporation is paid as a condition to its possession and use, thus becoming in the nature of a rental charge, such interest charge may be included in the deduction under this item. Mortgage indebtedness, assumed or unassumed, on property to which the corporation has taken or is taking title, or in which it has an equity, or in the requirement of which the mortgage was considered a part of the purchase price, is held to be a debt of the corporation, and interest paid on such indebtedness will be deductible only under item 6 of the return, and, together with other interest charges, must not exceed the limit fixed by the law for such interest deductions.

13. The amount claimed under item No. 5(b) for depreciation should be such an amount as measures the loss which the corporation actually sustains during the year in the value of buildings, machinery, and such other property as is subject to depreciation on account of wear and tear, exhaustion, or obsolescence. The amount taken credit for on this account in order to be allowable should be so entered on the books as to constitute and show as a liability against the assets of the corporation. The amount claimed under this item should not cover losses in

the value of stocks and bonds. The change in the value of stocks and bonds is properly taken up in the inventories or annual adjustment in the value of such securities and the income or losses indicated by this adjustment may be accounted for accordingly.

14. Where depreciation of physical property is made good by renewals, replacements, repairs, etc., and the expense of such renewals, replacements, repairs, etc., is charged to the general expense account, no deduction for depreciation can be made in the return of annual net income. Where a depreciation reserve is set up, all renewals and replacements must be charged to such reserve and the additions to this reserve each year must be a fair measure of the loss which the corporation sustains by reason of the depreciation of its property.

15. The amount of interest deductible is the amount of interest accrued and paid within the year on its bonded or other indebtedness not exceeding one-half of the sum of its interest-bearing indebtedness and its paid-up capital stock outstanding at the close of the year, or if no capital stock, the amount of interest paid within the year on an amount of indebtedness not exceeding the amount of capital employed in the business at the close of the year; or in case of a corporation, joint stock company, or association, or insurance company organized under the laws of a foreign country, interest so paid on its bonded or other indebtedness in the amount of such bonded or other indebtedness not exceeding the proportion of its paid-up capital stock outstanding at the close of the year, or if no capital stock, the amount of capital employed in the business at the close of the year, which the gross amount of its income for the year from business transacted and capital invested within the United States bears to the gross amount of its income derived from all sources within and without the United States.

All interest deductions must be claimed under item 6 on the return form.

16. Dividends declared or paid are not deductible from gross income.

17. Dividends received upon the stock of other corporations must be included in gross income and, under the provisions of the law, are not deductible therefrom in the ascertainment of the net income on which the tax is computed.

18. Interest received upon the obligations of a State or any political subdivision thereof and upon the obligations of the United States or its possessions should be included in gross income, as well as all other interest due and accrued during the period for which return is made.

19. Accrued interest is considered to be interest due and payable, except in the cases of banking or other similar institutions which close their accounts on the basis of the interest earned. In all cases the accrued interest shall be reported on the basis on which the books are closed.

20. Taxes for which credit may be taken in the return are such taxes, actually paid within the year, as are imposed by authority of the United States or of any State or Territory thereof, or by the government of any foreign country, not including taxes paid by a corporation, pursuant to guaranty, on its bonds or the income therefrom and not including those taxes assessed against local benefits. A reserve for taxes as such is not deductible, but only taxes actually paid.

21. Reinsurance (except as provided by Note 23) and return premiums should not be included in either gross income or deductions; as "not written premiums," agreeing with report to States, should be shown.

22. Mutual fire insurance companies which require their members to make premium deposits to provide for losses and expenses need not return as income any portion of the premium deposits returned to their policyholders.

23. Mutual marine insurance companies shall include in their return of gross income the gross premiums collected and received by them, less reinsurance. (See Note 21.)

24. Mutual marine insurance companies are entitled to deduct from gross income amounts repaid to policyholders on account of premiums previously paid by them and interest paid upon such amounts between the ascertainment thereof and the payment thereof.

25. Life insurance companies need not include as income in any year such portion of any actual premium received from any individual policyholder which shall have been paid back or credited to such individual policyholder, or treated as an abatement of premium of such individual policyholder within such year.

26. Mutual fire insurance companies must return as income such portions of premium deposits as are retained by the companies for purposes other than the payment of losses and expenses and reinsurance reserves.

27. The deduction allowed under the act of August 5, 1909, of amounts received as dividends upon stock of other corporations subject to the tax thereon is not allowed under the act of October 3, 1913.

28. In the case of assessment insurance companies, whether domestic or foreign, the actual deposits of sums with the State or Territorial officers pursuant to law, as additions to guarantee or reserve funds shall be treated as being payments required by law to reserve funds.

5-725

Income Tax Department

TO BE FILLED IN BY COLLECTOR.

FORM 1001.

TO BE FILLED IN BY INTERNAL REVENUE BUREAU.

List No. _____ Class _____

THE PENALTY for failure to have this Return in the hands of the Collector of Internal Revenue on or before March 1, or within 60 days after the close of the fiscal year, is a sum not exceeding \$10,000.

Assessment List _____, 191

District of _____

(See instructions on other side.)

Page _____ Line _____

Date received _____, 15

UNITED STATES INTERNAL REVENUE.

RETURN OF ANNUAL NET INCOME.

(Section 4, Act of Congress approved October 3, 1917.)

BANKS AND OTHER FINANCIAL INSTITUTIONS.

RETURN OF NET INCOME received during the {calendar} year ended _____, 191

by _____
(Name of banking or other financial institution.)

a corporation, the principal place of business of which is located at _____
(Street and No.)

City or Town of _____, in the State of _____

(The "year" as hereinafter used means the calendar year or fiscal year as the case may be.)

1. Total amount of paid-up capital stock outstanding at close of the year, or if no capital stock, the capital employed in the business at the close of the year \$ _____

2. Total amount of bonded and other indebtedness outstanding at close of year \$ _____

3. GROSS INCOME (see Note A, and instructions, paragraphs 10, 17, 18, and 19) \$ _____

DEDUCTIONS.

4. (a) Total amount of all the ordinary and necessary expenses paid within the year in the maintenance and operation of the business and properties of the corporation EXCEPTS OF FURNITURE PAYMENTS. (See Note B) \$ _____

(b) All rentals or other payments required to be made as a condition to the continued use or possession of the property. (See paragraph 13 on reverse of this form) \$ _____

5. (a) Total amount of losses sustained during the year not compensated by insurance or otherwise \$ _____

(b) Total amount of depreciation for the year \$ _____

6. (a) Total amount of interest, exclusive of interest on deposits, accrued and paid within the year on an amount of bonded or other indebtedness not exceeding one-half of the sum of its interest-bearing indebtedness and its paid-up capital stock outstanding at the close of the year; or if no capital stock, the amount of interest paid within the year on an amount of its indebtedness not exceeding the amount of capital employed in the business at the close of the year \$ _____

(b) Total amount of interest paid within the year on deposits \$ _____

(c) Total amount of interest received upon obligations of a State or political subdivision thereof, and upon the obligations of the United States or its possessions \$ _____

7. (a) Total taxes paid during the year imposed under authority of the United States or any State or Territory thereof \$ _____

(b) Foreign taxes paid \$ _____

TOTAL DEDUCTIONS \$ _____

8. Net income on which tax at 1 per centum is calculated \$ _____

STATE OF _____, County of _____, TO WIT:

_____, President, and _____, Treasurer, of

the _____, a corporation, whose return of annual net income is set forth above, being severally duly sworn, each for himself, deposes and says that the foregoing report and the several items therein set forth are, to his best knowledge and belief and from such information as he has been able to obtain, true and correct in each and every particular; that the amount of gross income therein set forth is the full amount of gross income, without any deduction whatsoever, received from all sources by the said corporation during the year stated, and that the net income therein set forth is the full amount upon which the tax at 1 per centum is to be calculated and assessed.

SWORN AND SUBSCRIBED to before me this _____

day of _____, 191

_____, President.



(Official capacity.)

_____, Treasurer.

NOTE A.—Gross income shall consist of the total revenues derived from the operation and management of its business and properties, together with all sources of income from other sources, including dividends received on stock of other organizations, whether subject to this tax or not, and interest received upon obligations of a State or political subdivision thereof, and upon the obligations of the United States or its possessions, as shown by entries upon its books during the year for which the return is made.

NOTE B.—The deductions authorized shall include all expenses incurred under the various heads acknowledged as liabilities by the corporation making the return and entered upon its books during the year. Amounts expended in paying dividends on stock, preferred or common, or in making permanent improvements or betterments, etc., or in any way transferred to capital account, should not be deducted in ascertaining annual net income. Interest paid on mortgage indebtedness on real estate accepted or used by a corporation may be deducted under item 4, if the interest is paid as a fixed charge, the payment of which is required to be made as a condition to the continued use and possession of the property. The amount so paid and included in item 4 should be stated separately under item 4 (b). (See paragraph 13 on reverse of this form.)

5-100

INSTRUCTIONS.

SPECIAL NOTICE.—THIS FORM, PROPERLY FILLED OUT AND EXECUTED, MUST BE IN THE HANDS OF THE COLLECTOR OF INTERNAL REVENUE FOR THE DISTRICT IN WHICH IS LOCATED THE PRINCIPAL BUSINESS OFFICE OF THE CORPORATION MAKING THE RETURN, ON OR BEFORE MARCH 1, IN CASE THE RETURN IS BASED ON THE CALENDAR YEAR, OR WITHIN 90 DAYS AFTER THE EXPIRATION OF THE FISCAL YEAR IN CASE THE RETURN IS MADE ON THAT BASIS.

FOR FAILURE TO COMPLY WITH THIS PROVISION OF THE LAW, THE AMOUNT OF THE ASSESSMENT IS INCREASED 50 PER CENT AND LIABILITY TO A SPECIFIC PENALTY NOT EXCEEDING \$10,000, IS INCURRED.

1. This return of annual net income should be filed with the Collector of Internal Revenue of the district in which the corporation has its principal place of business.

2. The principal place of business as used in the act and in these regulations is held to mean the place in which the books of account and other data to be used in preparing the return of annual net income are ordinarily kept.

3. Returns must be verified by two officers of the corporation; that is, by two individuals, namely, the president, vice president, or other principal officer, and treasurer or assistant treasurer, or chief financial officer.

4. The affidavit of verification must be made before a notary public or some other officer qualified to administer oaths, and the seal of the attesting officer, if such officer is required by law to have a seal, must be impressed on the return in the space reserved for that purpose.

5. The return must be true and accurate in every respect and must disclose all the income arising, accruing, or received from all sources during the year for which the return is made.

6. If the return is based upon the calendar year it should be filed with the collector on or before the first day of March next succeeding each calendar year. If it is made on the basis of business transacted during a fiscal year, duly designated in accordance with the law and the regulations, the return must be filed with the collector on or before the last day of the 90-day period next following the date designated as the close of the fiscal year.

7. In case of sickness or absence of an officer required to verify the return, the collector of the district is authorized to extend the time for filing such return not exceeding 30 days from the date when such return is otherwise due. Application for such extension should be made prior to the date when the return is due, or within the thirty-day period for which such extension is desired and can be granted.

8. Item No. 1 of the schedule on the reverse of this form should not include unissued or treasury stock, but only such stock as has actually been issued and for which payment has been received; or, in case no stock is issued, there should be reported under this item the amount of capital actually employed in the business and property of the corporation. In cases wherein the capital stock is issued payable in installments or upon assessment, only so much of the capital as has been actually paid in upon such installments or assessments should be reported under this item.

9. Item No. 2 should include all interest-bearing indebtedness for the payment of which the corporation or its property is bound. In case of banking corporations and like financial institutions, deposits should not be reported as indebtedness under this head.

10. Item No. 3 of the return form (gross income) should include all income derived from the operations and management of the business and property, together with all actual incomes in value by appreciation, adjustment, or otherwise in the value of the assets which have been taken up on the books as income or credited to profit and loss during the year. In the case of a corporation organized, authorized, or existing under the laws of any foreign country, the gross income to be returned is the gross amount of its income for the year resulting from business transacted and capital invested within the United States.

11. Item No. 4 (a) should include the total amount of all ordinary and necessary expenses paid out of earnings in the maintenance and operation of the business and property of the corporation, etc., exclusive of interest and other payments to be listed under their respective heads on the return form.

12. Item No. 4 (b) should include all rentals or other payments required to be made as a condition to the continued use or possession of the property. In cases where interest on a mortgage on property occupied or used by the corporation is paid as a condition to its possession and use, thus becoming in the nature of a rental charge, such interest charge may be included in the deduction under this item. Mortgage indebtedness, assumed or unassumed, on property to which the corporation has taken or is taking title, or in which it has an equity, or in the acquisition of which the mortgage was considered a part of the purchase price, is held to be a debt of the corporation and interest paid on such indebtedness will be deductible only under item 6 of the return.

13. The amount claimed under Item No. 5 (b) for depreciation should be such an amount as measures the loss which the corporation actually sustains during the year in the value of buildings, machinery, and such other property as is subject to depreciation on account of wear and tear, exhaustion, or obsolescence.

The amount taken credit by an allowance in order to be allowable should be so entered on the books to be constituting a liability against the assets of the corporation. The amount claimed under this item should not cover losses in the value of stocks and bonds. Decreases in the book value of securities owned, so far as such decreases represent a decline in the actual value of such securities, should be deducted under item 5 (a) of the return.

14. Where depreciation of physical property is made good by renewals, replacements, repairs, etc., and the expense of such renewals, replacements, repairs, etc., is charged to the general expense account, no deduction for depreciation can be made in the return of annual net income. Where a depreciation reserve is set up, all renewals and replacements must be charged to such reserve and the addition to this reserve each year must be a fair measure of the loss which the corporation sustains by reason of the depreciation of its property.

15. The amount of interest deductible is the amount of interest accrued and paid within the year on bonded or other indebtedness not exceeding one-half of the sum of last-bearing indebtedness and the paid-up capital stock outstanding at the close of the year, or if no capital stock, the amount of interest paid within the year on an amount of indebtedness not exceeding the amount of capital employed in the business at the close of the year; or in case of a corporation, joint stock company or association, or insurance company organized under the laws of a foreign country, interest so paid on its bonded or other indebtedness to an amount of such bonded or other indebtedness not exceeding the proportion of its paid-up capital stock outstanding at the close of the year, or if no capital stock, the amount of capital employed in the business at the close of the year, which the gross amount of its income for the year from business transacted and capital invested within the United States bears to the gross amount of its income derived from all sources within and without the United States. All interest deductions must be claimed under item 6 on the return form.

16. Dividends declared or paid are not deductible from gross income. Dividends received upon the stock of other corporations must be included in gross income and are not deductible therefrom in the computation of the net income on which the tax is computed.

17. Interest received upon the obligations of a State or any political subdivision thereof, and upon the obligations of the United States or its possessions, should be included in gross income, as well as all other interest due and accrued during the period for which the return is made.

18. Accrued interest is considered to be interest due and payable, except in the case of banking or other similar institutions which close their accounts on the basis of the interest earned. In all cases the accrued interest shall be reported on the basis on which the books are closed.

19. Taxes deductible in the return are such taxes, actually paid within the year, as are imposed by authority of the United States or any State or Territory thereof, or by the government of any foreign country, not including taxes paid by a corporation, pursuant to guaranty, on its bonds or the income therefrom and not including those taxes assessed against local benefits. A reserve for taxes, as such, is not deductible.

20. The gross income of mercantile corporations should be ascertained in the following manner: From the sum of the total sales during the year plus the sum of the inventory at the end of the year, deduct the sum of the inventory at the beginning of the year plus the sum of the goods and materials purchased during the year; to this difference add the income received from any other source and the result will be the gross income to be reported under item No. 3 of the return.

21. Gross income in the case of a manufacturing corporation shall include the total receipts from the sale of all manufactured goods sold during the year plus any increase in the inventoried value ascertained through an accounting of the finished and unfinished product, raw material, etc., on hand at the close of the year.

22. To the income thus ascertained there should be added the income arising, accruing, or received from any and all other sources, the aggregate thus ascertained to be the gross income to be returned under item No. 3 of the return form. Since the gross income thus ascertained represents the total receipts as well as the inventoried value of finished and unfinished products, raw material, etc., the corporation will include in its deduction under item No. 4 all expenditures for material, labor, fuel, and other items going to make up the cost of the goods sold or inventoried at the end of the year.

Income Tax Department

TO BE FILLED IN BY COLLECTOR.

Form 1002.

TO BE FILLED IN BY INTERNAL REVENUE BUREAU

Let No. _____ Class _____
District of _____
Date received _____, 191

THE PENALTY for failure to have this Return in the hands of the Collector of Internal Revenue on or before March 1, or within 90 days after the close of the fiscal year, is a sum not exceeding \$10,000.
(See instructions on other side.)

Assessment List _____, 191
Page _____ Line _____

UNITED STATES INTERNAL REVENUE.

RETURN OF ANNUAL NET INCOME.

(Section 5, Act of Congress approved October 3, 1917.)

PUBLIC SERVICE CORPORATIONS.

RETURN OF NET INCOME received during the {calendar} {fiscal} year ended _____, 191

by _____
(Name of corporation, joint stock company, or association.)

the principal place of business of which is located at _____
(Street and No.)

City or Town of _____, in the State of _____

(The "year" as hereinafter used means the calendar year or fiscal year as the case may be.)

1. Total amount of paid-up capital stock outstanding at close of the year, or if no capital stock, the capital employed in the business at the close of the year _____ \$ _____

2. Total amount of bonded and other indebtedness outstanding at close of year _____ \$ _____

3. GROSS INCOME (see Note A, and instructions, paragraphs 10, 17, 18, and 19) _____ \$ _____

DEDUCTIONS.

4. (a) Total amount of all the ordinary and necessary expenses paid within the year in the maintenance and operation of the business and properties of the corporation, EXCLUSIVE OF INTEREST PAYMENTS. (See Note B). _____ \$ _____

(b) All rentals or other payments required to be made as a condition to the continued use or possession of the property. (See paragraph 13 on reverse of this form) _____ \$ _____

5. (a) Total amount of losses sustained during the year not compensated by insurance or otherwise _____ \$ _____

(b) Total amount of depreciation for the year. (See paragraphs 13 and 14). _____ \$ _____

6. (a) Total amount of interest accrued and paid within the year on an amount of bonded or other indebtedness not exceeding one-half of the sum of its interest-bearing indebtedness and its paid-up capital stock outstanding at the close of the year, or if no capital stock, the amount of interest paid within the year on an amount of its indebtedness not exceeding the amount of capital employed in the business at the close of the year _____ \$ _____

(b) Total amount of interest received upon obligations of a State or political subdivision thereof, and upon the obligations of the United States or its possessions _____ \$ _____

7. (a) Total taxes paid during the year, imposed under authority of the United States or any State or Territory thereof _____ \$ _____

(b) Foreign taxes paid _____ \$ _____

TOTAL DEDUCTIONS _____ \$ _____

8. Net income on which tax at 1 per centum is calculated _____ \$ _____

STATE OF _____ County of _____, TO WIT:

_____, President, and _____, Treasurer, of

the _____, a corporation, whose return of annual net income is set forth above, being severally duly sworn, each for himself, depose and says that the foregoing report and the several items therein set forth are, to his best knowledge and belief and from such information as he has been able to obtain, true and correct in each and every particular; that the amount of gross income therein set forth is the full amount of gross income, without any deduction whatsoever, received from all sources by the said corporation during the year stated, and that the net income therein set forth is the full amount upon which the tax at 1 per centum is to be calculated and assessed.

SWORN AND SUBSCRIBED to before me this _____

day of _____, 191 _____ President.

SEAL OF
OFFICER
TAKING
AFFIDAVIT.

(Official capacity.)

Treasurer.

NOTE A.—Gross income shall consist of the total revenues derived from the operation and management of its business and properties, together with all amounts of income from other sources, including dividends received on stock of other corporations, whether subject to this tax or not, and interest received upon obligations of a State or political subdivision thereof, and upon the obligations of the United States or its possessions, as shown by entries upon its books during the year for which return is made.

NOTE B.—The deductions authorized shall include all expense items under the various heads acknowledged as liabilities by the corporation making the return and entered upon its books during the year. Amounts of income expended in paying dividends on stock, preferred or common, or in making permanent improvements or betterments, etc., or in any way transferred to capital account, should not be deducted in ascertaining annual net income. Interest paid on mortgage indebtedness on real estate occupied or used by a corporation may be deducted under item 4, if the interest is paid in rental or franchise charge, payment of which is required to be made as a condition to the continued use and possession of the property. The amount so paid and included in item 4 should be stated separately under item 4 (b). (See paragraph 13 on reverse of this form.)

The Journal of Accountancy

INSTRUCTIONS.

SPECIAL NOTICE.—THIS FORM, PROPERLY FILLED OUT AND EXECUTED, MUST BE IN THE HANDS OF THE COLLECTOR OF INTERNAL REVENUE FOR THE DISTRICT IN WHICH IS LOCATED THE PRINCIPAL BUSINESS OFFICE OF THE CORPORATION MAKING THE RETURN, ON OR BEFORE MARCH 1, IN CASE THE RETURN IS BASED ON THE CALENDAR YEAR, OR WITHIN 60 DAYS AFTER THE EXPIRATION OF THE FISCAL YEAR IN CASE THE RETURN IS MADE ON THAT BASIS.

FOR FAILURE TO COMPLY WITH THIS PROVISION OF THE LAW, THE AMOUNT OF THE ASSESSMENT IS INCREASED 50 PER CENT AND LIABILITY TO A SPECIFIC PENALTY NOT EXCEEDING \$10,000 IS INCURRED.

1. This return of annual net income should be filed with the Collector of Internal Revenue of the district in which the corporation has its principal place of business.

2. The principal place of business as used in the act and in these regulations is held to mean the place in which the books of account and other data to be used in preparing the return of annual net income are ordinarily kept.

3. Returns must be verified by two officers of the corporation; that is, by two individuals, namely, the president, vice president, or other principal officer, and treasurer or assistant treasurer, or chief financial officer.

4. The affidavit of verification must be made before a notary public or some other officer qualified to administer oaths, and the seal of the administering officer, if such officer is required by law to have a seal, must be impressed on the return in the space reserved for that purpose.

5. The return must be true and accurate in every respect and must disclose all the income arising, accruing, or received from all sources during the year for which the return is made.

6. If the return is based upon the calendar year it should be filed with the collector on or before the first day of March next succeeding such calendar year. If it is made on the basis of business transacted during a fiscal year, duly designated in accordance with the law and the regulations, the return must be filed with the collector on or before the last day of the 60-day period next following the date designated as the close of the fiscal year.

7. In case of sickness or absence of an officer required to verify the return, the collector of the district is authorized to extend the time for filing such return, not exceeding 30 days from the date when such return is otherwise due. Application for such extension should be made prior to the date when the return is due, or within the thirty-day period for which such extension is desired and has been granted.

8. Item No. 1 of the schedule on the reverse of this form should not include unmatured or treasury stock, but only such stock as has actually been issued and for which payment has been received; or, in case no stock is issued, there should be reported under this item the amount of capital actually employed in the business and property of the corporation. In cases wherein the capital stock is issued payable in installments or upon assessment, only so much of the capital as has been actually paid in upon such installments or assessments should be reported under this item.

9. Item No. 2 should include all interest-bearing indebtedness for the payment of which the corporation or its property is bound. In case of banking corporations and like financial institutions, deposits should not be reported as indebtedness under this head.

10. Item No. 3 of the return form (gross income) should include all income derived from the operations and management of the business and properties, together with all actual increases in value by appreciation, adjustment, or otherwise in the value of the assets which have been taken up on the books as income or credited to profit and loss during the year. In the case of a corporation organized, authorized, or existing under the laws of any foreign country, the gross income to be returned is the gross amount of its income for the year resulting from business transacted and capital invested within the United States.

11. Item No. 4 (a) should include the total amount of all ordinary and necessary expenses paid out of earnings in the maintenance and operation of the business and properties of the corporation, etc., exclusive of interest and other payments to be listed under their respective heads on the return forms.

12. Item No. 4 (b) should include all rentals or other payments required to be made as a condition to the continued use or possession of this property. In cases where interest on a mortgage on property occupied or used by the corporation is paid as a condition to its possession and use, thus becoming in the nature of a rental charge, such interest charge may be included in the deduction under this item. Mortgages indebtedness, assumed or unassumed, on property to which the corporation has taken or is taking title, or in which it has an equity, or in the acquisition of which the mortgage was considered a part of the purchase price, is held to be a debt of the corporation and interest paid on such indebtedness will be deductible only under Item 6 of the return.

13. The amount claimed under Item No. 5 (b) for depreciation should be such an amount as represents the loss which the corporation actually sustains during the year in the value of buildings, machinery, and such other property as is subject to depreciation on account of wear and tear, exhaustion, or obsolescence.

The amount taken credit for on this account in order to be allowable should be as entered on the books as to constitute a liability against the assets of the corporation. The amount claimed under this item should not cover losses in the value of stocks and bonds. Decreases in the book value of securities owned, so far as such decreases represent a decline in the actual value of such securities, should be deducted under item 5 (c) of the return.

14. Where depreciation of physical property is made good by renewals, replacements, repairs, etc., and the expense of such renewals, replacements, repairs, etc., is charged to the general expense account, no deduction for depreciation can be made in the return of annual net income. Where a depreciation reserve is set up, all renewals and replacements must be charged to such reserve and the addition to this reserve each year must be a fair measure of the loss which the corporation sustains by reason of the depreciation of its property.

15. The amount of interest deductible is the amount of interest accrued and paid within the year on bonded or other indebtedness not exceeding one-half of the sum of interest-bearing indebtedness and the paid-up capital stock outstanding at the close of the year, or if no capital stock; the amount of interest paid within the year on an amount of indebtedness not exceeding the amount of capital employed in the business at the close of the year; or, in case of a corporation, joint stock company or association, or insurance company organized under the laws of a foreign country, interest so paid on its bonded or other indebtedness to an amount of such bonded or other indebtedness not exceeding the proportion of its paid-up capital stock outstanding at the close of the year, or if no capital stock, the amount of capital employed in the business at the close of the year, which the gross amount of its income for the year from business transacted and capital invested within the United States bears to the gross amount of its income derived from all sources within and without the United States. All interest deductions must be claimed under Item 6 on the return form.

16. Dividends declared or paid are not deductible from gross income.

17. Dividends received upon the stock of other corporations must be included in gross income and are not deductible therefrom in the ascertainment of the net income on which the tax is computed.

18. Interest incurred upon the obligations of a State or any political subdivision thereof, and upon the obligations of the United States or its possessions, should be included in gross income, as well as all other interest due and so paid during the period for which return is made.

19. Accrued interest is considered to be interest due and payable, except in the cases of banking or other similar institutions which close their accounts on the basis of the interest earned. In all cases the accrued interest shall be reported on the basis on which the books are closed.

20. Taxes deductible in the return are such taxes, actually paid within the year, as are imposed by authority of the United States or of any State or Territory thereof, or by the government of any foreign country, not including taxes paid by a corporation, pursuant to judgment, on its bonds or the income therefrom and not including those taxes assessed against local benefits. A reserve for taxes, as such, is not deductible.

21. The gross income of taxable corporations should be ascertained in the following manner: From the sum of the total sales during the year plus the gain at the inventory at the end of the year, deduct the sum of the inventory at the beginning of the year plus the cost of the goods and materials purchased during the year; to this difference add the income received from any other source and the result will be the gross income to be reported under Item No. 3 of the return.

22. Gross income in the case of a manufacturing corporation shall include the total receipts from the sale of all manufactured goods sold during the year plus any increase in the inventoried value ascertained through an accounting of the finished and unfinished product, raw material, etc., on hand at the close of the year.

23. To the income thus ascertained there should be added the income arising, accruing, or received from any and all other sources, the aggregate thus ascertained to be the gross income to be returned under Item No. 3 of the return form. Since the gross income thus ascertained represents the total receipts as well as the inventoried value of finished and unfinished products, raw material, etc., the corporation will include in its deduction under Item No. 4 all expenditures for material, labor, fuel, and other items going to make up the cost of the goods sold or inventoried at the end of the year.

Income Tax Department

TO BE FILLED IN BY COLLECTOR.

Form 1002.

TO BE FILLED IN BY INTERNAL REVENUE BUREAU.

Ref No. _____ Class _____
 District of _____
 Date received _____ 191

THE PENALTY for failure to have this Return in the hands of the Collector of Internal Revenue on or before March 1, or within 60 days after the close of the fiscal year, is a sum not exceeding \$10,000.
 See instructions on other side.

Assessment List _____ 191
 Page _____ Line _____

UNITED STATES INTERNAL REVENUE.

RETURN OF ANNUAL NET INCOME. (Section 2, Act of Congress approved October 3, 1913.)

MANUFACTURING CORPORATIONS.

RETURN OF NET INCOME received during the ^{calendar} fiscal year ended _____ 191

by _____
 (Name of corporation, joint stock company, or association.)

the principal place of business of which is located at _____
 (Street and No.)

City or Town of _____ in the State of _____

(The "year" as hereinafter used means the calendar year or fiscal year as the case may be.)

1. Total amount of paid-up capital stock outstanding at close of the year, or if no capital stock, the capital employed in the business at the close of the year _____ \$
2. Total amount of bonded and other indebtedness outstanding at close of year _____ \$
3. Gross Income (see Note A, and instructions, paragraphs 10, 17, 18, 19, 22, and 23) _____ \$

DEDUCTIONS.

4. (a) Total amount of all the ordinary and necessary expenses paid within the year in the maintenance and operation of the business and properties of the corporation **EXCLUSIVE OF DEPRECIATION PAYMENTS** (see Note B and paragraph 23) _____ \$
- (b) All rentals or other payments required to be made as a condition to the continued use or possession of the property (see paragraph 12 on reverse of this form) _____ \$
5. (a) Total amount of losses sustained during the year not compensated by insurance or otherwise _____ \$
- (b) Total amount of depreciation for the year (see paragraphs 13 and 14) _____ \$
6. (a) Total amount of interest accrued and paid within the year on an amount of bonded or other indebtedness not exceeding one-half of the sum of its interest-bearing indebtedness and its paid-up capital stock outstanding at the close of the year, or if no capital stock, the amount of interest paid within the year on an amount of its indebtedness not exceeding the amount of capital employed in the business at the close of the year _____ \$
- (b) Total amount of interest received upon the obligations of a State or political subdivision thereof, and upon the obligations of the United States or its possessions _____ \$
7. (a) Total taxes paid during the year, imposed under authority of the United States or any State or Territory thereof _____ \$
- (b) Foreign taxes paid _____ \$

Total Deductions _____ \$

8. Net income on which tax at 1 per centum is calculated _____ \$

Note.—The above blank spaces for figures should show the amount of each respective item. If there is nothing to return as to any item, the word "none" must be written in each blank space.

STATE OF _____, County of _____, TO WIT:

_____, President, and _____, Treasurer, of

the _____ a corporation, whose return of annual net income is set forth above, being severally duly sworn, each for himself, depose and says that the foregoing report and the several items therein set forth are, to his best knowledge and belief and from such information as he has been able to obtain, true and correct in each and every particular; that the amount of gross income therein set forth is the full amount of gross income, without any deduction whatsoever, received from all sources by the said corporation during the year stated, and that the net income therein set forth is the full amount upon which the tax at 1 per centum is to be calculated and assessed:

SWORN AND SUBSCRIBED to before me this _____

day of _____, 191

_____, President.

SEAL OF
OFFICER
TAKING
AFFIDAVIT.

(Official capacity.)

_____, Treasurer.

Note A.—Gross income in the case of a manufacturing corporation shall include the total receipts from all manufactured goods sold during the year, increased or decreased accordingly as there is gain or loss ascertained through an accounting or inventory of the finished and unfinished product, per material, etc., on hand at the close of the year. To the income thus ascertained there should be added the income received from any and all other sources, including dividends received on stock of other organizations, whether subject to this tax or not, and interest received on the obligations of a State or political subdivision thereof, and interest received on the obligations of the United States or its possessions, the aggregate to be the gross income returned.

Note B.—The deductions authorized shall include all expense items under the various heads acknowledged as liabilities by the corporation making the return and entered on its books during the year. "Total amount of all ordinary and necessary expenses," etc., shall include expenditures for material, labor, salaries, wages, fuel, and other expenses incident to the cost of the finished product. Amounts of income expended in paying dividends on stock, preferred or common, or in making permanent improvements or betterments, etc., or in any way transferred to property account, should not be deducted in ascertaining the net income upon which the tax is computed. Interest paid on rental or in lieu of rental is deductible under item 6 (b). (See paragraph 12 on the reverse of this form.)

e2-7205

The Journal of Accountancy

INSTRUCTIONS

SPECIAL NOTICE—THIS FORM, PROPERLY FILLED OUT AND EXECUTED, MUST BE IN THE HANDS OF THE COLLECTOR OF INTERNAL REVENUE FOR THE DISTRICT IN WHICH IS LOCATED THE PRINCIPAL BUSINESS OFFICE OF THE CORPORATION MAKING THE RETURN, ON OR BEFORE MARCH 1, IN CASE THE RETURN IS BASED ON THE CALENDAR YEAR, OR WITHIN 90 DAYS AFTER THE EXPIRATION OF THE FISCAL YEAR IN CASE THE RETURN IS MADE ON THAT BASIS.

FOR FAILURE TO COMPLY WITH THIS PROVISION OF THE LAW, THE AMOUNT OF THE ASSESSMENT IS INCREASED 50 PER CENT AND LIABILITY TO A SPECIFIC PENALTY NOT EXCEEDING \$10,000 IS INCURRED.

1. This return of annual net income should be filed with the Collector of Internal Revenue of the district in which the corporation has its principal place of business.

2. The principal place of business as used in the act and in these regulations is held to mean the place in which the books of account and other data to be used in preparing the return of annual net income are ordinarily kept.

3. Returns must be verified by two officers of the corporation; that is, by two individuals, namely, the president, vice president, or other principal officer, and treasurer or assistant treasurer, or chief financial officer.

4. The affidavit of verification must be made before a notary public or some other officer qualified to administer oaths, and the seal of the attesting officer. If such officer is required by law to have a seal, must be impressed on the return in the space reserved for that purpose.

5. The return must be true and accurate in every respect and must disclose all the income arising, accruing, or received from all sources during the year for which the return is made.

6. If the return is based upon the calendar year it should be filed with the collector on or before the first day of March next succeeding such calendar year. If it is made on the basis of business transacted during a fiscal year, duly designated in accordance with the law and the regulations, the return must be filed with the collector on or before the last day of the 60-day period next following the date designated as the close of the fiscal year.

7. In case of sickness or absence of an officer required to verify the return, the collector of the district is authorized to extend the time for filing such return not exceeding 30 days from the date when such return is otherwise due. Application for such extension should be made prior to the date when the return is due, or within the 30-day period for which such extension is desired and can be granted.

8. Item No. 1 of the schedule on the reverse of this form should not include unmatured or treasury stock, but only such stock as has actually been issued and for which payment has been received; or, in case no stock is issued, there should be reported under this item the amount of capital actually employed in the business and property of the corporation. In cases wherein the capital stock is issued payable in installments or upon assessment, only so much of the capital as has been actually paid in upon such installments or assessments should be reported under this item.

9. Item No. 2 should include all interest-bearing indebtedness for the payment of which the corporation or its property is bound. In case of banking corporations and life financial institutions, deposits should not be reported as indebtedness under this head.

10. Item No. 3 of the return form (gross income) should include all income derived from the operations and management of the business and properties, together with all actual increases in value by appreciation, adjustment, or otherwise in the value of the assets which have been taken up on the books as income or credited to profits and loss during the year. In the case of a corporation organized, authorized, or existing under the laws of any foreign country, the gross income to be returned is the gross amount of its income for the year resulting from business transacted and capital invested within the United States.

11. Item No. 4 (a) should include the total amount of all ordinary and necessary expenses paid out of earnings in the maintenance and operation of the business and properties of the corporation, etc., exclusive of interest and other payments to be listed under their respective heads on the return form.

12. Item No. 4 (b) should include all rentals or other payments required to be made as a condition to the continued use or possession of the property. In cases where interest on a mortgage on property occupied or used by the corporation is paid as a condition to its possession and use, such becoming in the nature of a rental charge, such interest charge may be included in the deduction under this item. Mortgages indebtedness, assumed or managed, on property in which the corporation has taken or is taking title, or in which it has an equity, or in the acquisition of which the mortgage was considered a part of the purchase price, is held to be a debt of the corporation and interest paid on such indebtedness will be deductible only under Item 6 of the return.

13. The amount claimed under Item No. 5 (b) for depreciation should be such an amount as measures the loss which the corporation actually sustains during the year in the value of buildings, machinery, and such other property as is subject to depreciation on account of wear and tear, exhaustion, or obsolescence.

The amount taken credit for on this account in order to be allowable should be as entered on the books as to constitute a liability against the assets of the corporation. The amount claimed under this item should not cover losses in the value of stocks and bonds. Decreases in the book value of securities owned, so far as such decreases represent a decline in the actual value of such securities, should be deducted under Item 5 (a) of the return.

14. Where depreciation of physical property is made good by renewals, replacements, repairs, etc., and the expense of such renewals, replacements, repairs, etc., is charged to the general expense account, no deduction for depreciation can be made in the return of annual net income. Where a depreciation reserve is set up, all renewals and replacements must be charged to such reserve and the addition to this reserve each year must be a fair measure of the loss which the corporation sustains by reason of the depreciation of its property.

15. The amount of interest deductible is the amount of interest accrued and paid within the year on bonded or other indebtedness not exceeding one-half of the sum of interest-bearing indebtedness and the paid-up capital stock outstanding at the close of the year, or if no capital stock, the amount of interest paid within the year on an amount of indebtedness not exceeding the amount of capital employed in the business at the close of the year; or in case of a corporation, joint stock company or association, or insurance company organized under the laws of a foreign country, interest as paid on its bonded or other indebtedness to an amount of such bonded or other indebtedness not exceeding the proportion of its paid-up capital stock outstanding at the close of the year, or if no capital stock, the amount of capital employed in the business at the close of the year, which is the gross amount of its income for the year from business transacted and capital invested within the United States less the gross amount of its income derived from all sources within and without the United States. All interest deductions must be claimed under Item 6 on the return form.

16. Dividends declared or paid are not deductible from gross income.

17. Dividends received upon the stock of other corporations must be included in gross income and are not deductible therefrom in the ascertainment of the net income on which the tax is computed.

18. Interest received upon the obligations of a State or any political subdivision thereof, and upon the obligations of the United States or its possessions, should be included in gross income, as well as all other interest due and accrued during the period for which return is made.

19. Accrued interest is considered to be interest due and payable, except in the case of banking or other similar institutions which close their accounts on the basis of the interest earned. In all cases the accrued interest shall be reported on the basis on which the books are closed.

20. Taxes deductible in the return are such taxes, actually paid within the year, as are imposed by authority of the United States or of any State or Territory thereof, or by the government of any foreign country, not including taxes paid by a corporation, pursuant to guaranty, on its bonds or the income thereon, and not including those taxes assessed against local benefits. A reserve for taxes, as such, is not deductible.

21. The gross income of mercantile corporations should be ascertained in the following manner: From the sum of the total sales during the year plus the sum of the inventory at the end of the year, deduct the sum of the inventory at the beginning of the year plus the cost of the goods and materials purchased during the year; to this difference add the income received from any other source and the result will be the gross income to be reported under Item No. 3 of the return.

22. Gross income in the case of a manufacturing corporation shall include the total receipts from the sale of all manufactured goods sold during the year plus any increase in the inventoried values ascertained through an accounting of the finished and unfinished product, raw material, etc., on hand at the close of the year.

23. To the income thus ascertained there should be added the income arising, accruing, or received from any and all other sources, the aggregate thus ascertained to be the gross income to be returned under Item No. 3 of the return form. Since the gross income thus ascertained represents the total receipts as well as the inventoried value of finished and unfinished products, raw material, etc., the corporation will include in its deduction under Item No. 4 all expenditures for material, labor, fuel, and other items going to make up the cost of the goods sold or inventoried at the end of the year.

SPECIAL NOTICE—ANY OFFICER OF ANY CORPORATION REQUIRED BY LAW TO MAKE, RENDER, SIGN OR VERIFY ANY RETURN, WHO MAKES ANY FALSE OR FRAUDULENT RETURN OR STATEMENT WITH INTENT TO DEFEAT OR EVADE THE ASSESSMENT REQUIRED BY SECTION 2, ACT OF OCTOBER 3, 1917, TO BE MADE, SHALL BE GUILTY OF A MISDEMEANOR AND SHALL BE FINED NOT EXCEEDING \$2,000, OR BE IMPRISONED NOT EXCEEDING ONE YEAR, OR BOTH, AT THE DISCRETION OF THE COURT, WITH THE COSTS OF PROSECUTION.

4-5-2021

Income Tax Department

TO BE FILLED IN BY COLLECTORS.

Form 1004.

TO BE FILLED IN BY INTERNAL REVENUE BUREAU.

Int No. _____ Date _____
 District of _____
 Date received _____ 191
 THE PERSONALTY for failure to have this return
 at the hands of the collector of Internal
 Revenue on or before March 1, or within 60
 days after the close of the fiscal year, is a
 sum not exceeding \$20,000.
 (See instructions on other side.)
 Assessment List _____, 101
 Page _____ Line _____

UNITED STATES INTERNAL REVENUE.

RETURN OF ANNUAL NET INCOME.

(Section 2, Act of Congress approved October 3, 1917.)

MERCANTILE CORPORATIONS.

(Corporations whose principal business is buying and selling.)

RETURN OF NET INCOME received during the {calendar} year ended _____ 191

by _____
 (Name of corporation, joint stock company, or association.)

the principal place of business of which is located at _____
 (Street and No.)

City or Town of _____ in the State of _____

(The "year" as hereinafter used means the calendar year or fiscal year as the case may be.)

1. Total amount of paid-up capital stock outstanding at close of the year, or if no capital stock, the capital employed in the business at the close of the year. _____

2. Total amount of bonded and other indebtedness outstanding at close of year. _____

3. GROSS INCOME (see Note A, and instructions, paragraphs 10, 17, 18, 19, and 31) _____

DEDUCTIONS.

4. (a) Total amount of all the ordinary and necessary expenses paid within the year in the maintenance and operation of the business and properties of the corporation EXCLUSIVE OF INTEREST PAYMENTS (see Note B) _____

(b) All rentals or other payments required to be made as a condition to the continued use or possession of the property (see paragraph 13 on reverse of this form) _____

5. (a) Total amount of losses sustained during the year not compensated by insurance or otherwise. _____

(b) Total amount of depreciation for the year. _____

6. (a) Total amount of interest accrued and paid within the year on an amount of bonded and other indebtedness not exceeding one-half of the sum of its interest-bearing indebtedness and its paid-up capital stock outstanding at the close of the year; or if no capital stock, the amount of interest paid within the year on an amount of its indebtedness not exceeding the amount of capital employed in the business at the close of the year _____

(b) Total amount of interest received upon obligations of a State or political subdivision thereof and upon the obligations of the United States or its possessions _____

7. (a) Total taxes paid during the year, imposed under authority of the United States or any State or Territory thereof _____

(b) Foreign taxes paid _____

TOTAL DEDUCTIONS _____

8. Net income on which tax at 1 per centum is calculated _____

NOTE.—The above blank space for figures should show the amount of each respective item. If there is nothing to return as to any item, the word "none" must be written in each blank space.

STATE OF _____ County of _____, TO WIT:

_____, President, and _____, Treasurer, of

the _____, a corporation, whose return of annual net income is set forth above, being severally duly sworn, each for himself, depose and says that the foregoing report and the several items therein set forth are, to his best knowledge and belief and from such information as he has been able to obtain, true and correct in each and every particular; that the amount of gross income therein set forth is the full amount of gross income, without any deduction whatsoever, received from all sources by the said corporation during the year stated, and that the net income therein set forth is the full amount upon which the tax at 1 per centum is to be calculated and assessed.

SWORN AND SUBSCRIBED to before me this _____

day of _____, 191

_____, President.

SEAL OF
 OFFICER
 TAKING
 AFFIDAVIT.

(Noted separately.)

_____, Treasurer.

NOTE A.—The gross amount of income received during the year from all sources shall, in the case of a mercantile corporation, consist of the total amount ascertained through inventory, of its investments, which shows the difference between the price received for goods sold and the cost of goods purchased during the year, with an addition of a charge to the account of the sum of the inventory at beginning of the year and a credit to the account of the sum of the inventory at the end of the year. To this amount should be added all items of income received during the year from other sources, including dividends received on stock of other corporations, joint-stock companies, and associations, whether subject to this tax or not, interest received upon obligations of a State or political subdivision thereof, and upon the obligations of the United States or its possessions. In determining this amount an account shall be taken of allowances for depreciation or losses, which items shall be taken account of under the proper heading above as a deduction.

NOTE B.—The deductions authorized shall include all expense items under the various heads acknowledged as liabilities by the corporation making the return and entered on its books during the year. Amounts of income expended in paying dividends on stock, preferred or common, or in making permanent improvements or betterments, etc., or in any way transferred to capital account, should not be deducted in ascertaining annual net income. Interest paid on mortgage indebtedness on real estate occupied or used by a corporation may be deducted in Item 4, if the interest is paid as a rental or leasehold charge, payment of which is required to be made as a condition to the continued use and possession of the property. The amount so paid and included in Item 4 should, however, be separately stated under Item 4 (b). (See paragraph 13 on reverse of this form.)

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INSTRUCTIONS.

SPECIAL NOTICE.—THIS FORM, PROPERLY FILLED OUT AND EXECUTED, MUST BE IN THE HANDS OF THE COLLECTOR OF INTERNAL REVENUE FOR THE DISTRICT IN WHICH IS LOCATED THE PRINCIPAL BUSINESS OFFICE OF THE CORPORATION MAKING THE RETURN, ON OR BEFORE MARCH 1, IN CASE THE RETURN IS BASED ON THE CALENDAR YEAR, OR WITHIN 90 DAYS AFTER THE EXPIRATION OF THE FISCAL YEAR IN CASE THE RETURN IS MADE ON THAT BASIS.

FOR FAILURE TO COMPLY WITH THIS PROVISION OF THE LAW, THE AMOUNT OF THE ASSESSMENT IS INCREASED 50 PER CENT AND LIABILITY TO A SPECIFIC PENALTY NOT EXCEEDING \$10,000 IS INCURRED.

1. This return of annual net income should be filed with the Collector of Internal Revenue of the district in which the corporation has its principal place of business.

2. The principal place of business as used in the act and in these regulations is held to mean the place in which the books of account and other data to be used in preparing the return of annual net income are ordinarily kept.

3. Returns must be verified by two officers of the corporation; that is, by two individuals, namely, the president, vice president, or other principal officer, and treasurer or assistant treasurer, or chief financial officer.

4. The affidavits of verification must be made before a notary public or some other officer qualified to administer oaths, and the seal of the attesting officer, if such officer is required by law to have a seal, must be impressed on the return in the space reserved for that purpose.

5. The return must be true and accurate in every respect and must disclose all the income arising, accruing, or received from all sources during the year for which the return is made.

6. If the return is based upon the calendar year it should be filed with the collector on or before the first day of March next succeeding such calendar year. If it is made on the basis of business transacted during a fiscal year, duly designated in accordance with the law and the regulations, the return must be filed with the collector on or before the last day of the 90-day period next following the date designated as the close of the fiscal year.

7. In case of sickness or absence of an officer required to verify the return, the collector of the district is authorized to extend the time for filing such return not exceeding 30 days from the date when such return is otherwise due. Application for such extension should be made prior to the date when the return is due, or within the 90-day period for which such extension is desired and can be granted.

8. Item No. 1 of the schedule on the obverse of this form should not include bonded or treasury stock, but only such stock as has actually been issued and for which payment has been received; or, in case no stock is issued, there should be reported under this item the amount of capital actually employed in the business and property of the corporation. In case wherein the capital stock is issued payable in installments or upon assessment, only so much of the capital as has been actually paid in upon such installments or assessments should be reported under this item.

9. Item No. 2 should include all interest-bearing indebtedness for the payment of which the corporation or its property is bonded. In case of banking corporations and like financial institutions, deposits should not be reported as indebtedness under this item.

10. Item No. 3 of the return form (gross income) should include all income derived from the operations and management of the business and property, together with all actual incomes in value by appreciation, adjustment, or otherwise in the value of the assets which have been taken up on the books as income or credited to profit and loss during the year. In the case of a corporation organized, authorized, or existing under the laws of any foreign country, the gross income to be returned is the gross amount of its income for the year resulting from business transacted and capital invested within the United States.

11. Item No. 4 (a) should include the total amount of all ordinary and necessary expenses paid out of earnings in the maintenance and operation of the business and properties of the corporation, etc., exclusive of interest and other payments to be listed under their respective heads on the return form.

12. Item No. 4 (b) should include all rentals or other payments required to be made as a condition to the continued use or possession of the property. In case where interest on a mortgage on property occupied or used by the corporation is paid as a condition to its possession and use, thus becoming in the nature of a rental charge, such interest charge may be included in the deduction under this item. Mortgage indebtedness, assumed or unassumed, on property to which the corporation has taken or is taking title, or in which it has an equity, or in the acquisition of which the mortgage was considered a part of the purchase price, is held to be a debt of the corporation and interest paid on such indebtedness will be deductible only under Item 6 of the return.

13. The amount claimed under Item No. 5 (b) for depreciation should be such an amount as measures the less which the corporation actually sustains during the year in the value of buildings, machinery, and such other property as is subject to depreciation on account of wear and tear, exhaustion, or obsolescence.

The amount taken credit for on this account in order to be allowable should be entered on the books as to constitute a liability against the assets of the corporation. The amount claimed under this item should not cover losses in the value of stocks and bonds. Decrease in the book value of securities owned, as far as such decrease represents a decline in the actual value of such securities, should be deducted under Item 5 (a) of the return.

14. Where depreciation of physical property is made good by renewals, replacements, repairs, etc., and the expense of such renewals, replacements, repairs, etc., is charged to the general expense account, no deduction for depreciation can be made in the return of annual net income. Where a depreciation reserve is set up, all renewals and replacements must be charged to such reserve and the addition to this reserve each year must be a fair measure of the loss which the corporation sustains by reason of the depreciation of its property.

15. The amount of interest deductible is the amount of interest accrued and paid within the year on bonded or other indebtedness not exceeding one-half of the sum of interest-bearing indebtedness and the paid-up capital stock outstanding at the close of the year, or if no capital stock, the amount of interest paid within the year on an amount of indebtedness not exceeding the amount of capital employed in the business at the close of the year; or in case of a corporation, paid stock company or association, or insurance company organized under the laws of a foreign country, interest so paid on its bonded or other indebtedness to an amount of such bonded or other indebtedness not exceeding the proportion of its paid-up capital stock outstanding at the close of the year, or if no capital stock, the amount of capital employed in the business at the close of the year, which the gross amount of its income for the year from business transacted and capital invested within the United States bears to the gross amount of its income derived from all sources within and without the United States. All interest deductions must be claimed under Item 6 on the return form.

16. Dividends declared or paid are not deductible from gross income. 17. Dividends received upon the stock of other corporations must be included in gross income and are not deductible therefrom in the ascertainment of this net income on which the tax is computed.

18. Interest received upon the obligations of a State or any political subdivision thereof, and upon the obligations of the United States or its Territories thereof, or by the government of any foreign country, not including taxes paid by a corporation, pursuant to guaranty, on its bonds or the income thereon and not including those taxes assessed against local benefits. A reserve for taxes, as such, is not deductible.

19. Accrued interest is considered to be interest due and payable, except in the case of banking or other similar institutions which close their accounts on the basis of the interest earned. In all cases the accrued interest shall be reported on the basis on which the books are closed.

20. Taxes deductible in the return are such taxes, actually paid within the year, so far imposed by authority of the United States or of any State or Territory thereof, or by the government of any foreign country, not including taxes paid by a corporation, pursuant to guaranty, on its bonds or the income thereon and not including those taxes assessed against local benefits. A reserve for taxes, as such, is not deductible.

21. The gross income of mercantile corporations should be ascertained in the following manner: From the sum of the total sales during the year plus the map of the inventory at the end of the year, deduct the sum of the inventory at the beginning of the year plus the cost of the goods and materials purchased during the year; to this difference add the income received from any other source and the result will be the gross income to be reported under Item No. 3 of the return.

22. Gross income in the case of a manufacturing corporation shall include the total receipts from the sale of all manufactured goods sold during the year plus any increases in the inventoried value ascertained through an accounting of the finished and unfinished product, raw material, etc., on hand at the close of the year.

23. To the income thus ascertained there should be added the income arising, accruing, or received from any and all other sources, the aggregate thus ascertained to be the gross income to be returned under Item No. 3 of the return form. Since the gross income thus ascertained represents the total receipts as well as the inventoried value of finished and unfinished products, raw material, etc., the corporation will include in its deduction under Item No. 4 all expenditures for material, labor, fuel, and other items going to make up the cost of the goods sold or inventoried at the end of the year.

SPECIAL NOTICE.—ANY OFFICER OF ANY CORPORATION REQUIRED BY LAW TO MAKE, RENDER, SIGN OR VERIFY ANY RETURN, WHO MAKES ANY FALSE OR FRAUDULENT RETURN OR STATEMENT WITH INTENT TO DEFEAT OR EVADE THE ASSESSMENT REQUIRED BY SECTION 2, ACT OF OCTOBER 3, 1917, TO BE MADE, SHALL BE GUILTY OF A MISDEMEANOR AND SHALL BE FINED NOT EXCEEDING \$2,500, OR BE IMPRISONED NOT EXCEEDING ONE YEAR, OR BOTH, AT THE DISCRETION OF THE COURT, WITH THE COSTS OF PROSECUTION.

Income Tax Department

TO BE FILLED IN BY COLLECTORS.

Form 1035.

TO BE FILLED IN BY INTERNAL REVENUE BUREAU.

List No. _____ Class _____
 District of _____
 Date received _____, 191

THE PENALTY for failure to have this Return in the hands of the Collector of Internal Revenue on or before March 1, or within 60 days after the close of the fiscal year, is a sum not exceeding \$10,000.
 (See instructions on other side.)

Assessment List _____, 191
 Page _____ Line _____

UNITED STATES INTERNAL REVENUE.

RETURN OF ANNUAL NET INCOME.

(Section 9, Act of Congress approved October 3, 1913.)

MISCELLANEOUS CORPORATIONS.

RETURN OF NET INCOME received during the {calendar / fiscal} year ended _____, 191

by _____
 (Name of corporation, joint stock company, or association.)

the principal place of business of which is located at _____
 (Street and No.)

City, or Town of _____, in the State of _____

(The "year" as hereinafter used means the calendar year or fiscal year as the case may be.)

1. Total amount of paid-up capital stock outstanding at close of the year, or if no capital stock, the capital employed in the business at the close of the year _____ \$ _____

2. Total amount of bonded and other indebtedness outstanding at close of year _____ \$ _____

3. GROSS INCOME (see Note A, and instructions, paragraphs 10, 17, 18, and 19) _____ \$ _____

DEDUCTIONS.

4. (a) Total amount of all the ordinary and necessary expenses paid within the year in the maintenance and operation of the business and properties of the corporation, EXCLUSIVE OF INTEREST PAYMENTS. (See Note B.) _____ \$ _____

(b) All rentals or other payments required to be made as a condition to the continued use or possession of the property. (See paragraph 12 on reverse of this form.) _____ \$ _____

5. (a) Total amount of losses sustained during the year not compensated by insurance or otherwise _____ \$ _____

(b) Total amount of depreciation for the year. (See paragraphs 13 and 14.) _____ \$ _____

6. (a) Total amount of interest accrued and paid within the year on an amount of bonded or other indebtedness not exceeding one-half of the sum of its interest-bearing indebtedness and its paid-up capital stock outstanding at the close of the year, or if no capital stock, the amount of interest paid within the year on an amount of its indebtedness not exceeding the amount of capital employed in the business at the close of the year _____ \$ _____

(b) Total amount of interest received upon obligations of a State or political subdivision thereof, and upon the obligations of the United States or its possessions _____ \$ _____

7. (a) Total taxes paid during the year imposed under authority of the United States or any State or Territory thereof _____ \$ _____

(b) Foreign taxes paid _____ \$ _____

TOTAL DEDUCTIONS _____ \$ _____

8. Net income on which tax at 1 per centum is calculated _____ \$ _____

Note.—The above blank spaces for figures should show the amount of each respective item. If there is nothing to return as to any item, the word "none" must be written in each blank space.

STATE _____, County of _____, TO WIT:
 _____, President, and _____, Treasurer, of

the _____, a corporation, whose return of annual net income is set forth above, being severally duly sworn, each for himself, depose and say that the foregoing report and the several items therein set forth are, to his best knowledge and belief and from such information as he has been able to obtain, true and correct in each and every particular; that the amount of gross income therein set forth is the full amount of gross income, without any deduction whatsoever, received from all sources by the said corporation during the year stated, and that the net income therein set forth is the full amount upon which the tax at 1 per centum is to be calculated and assessed.

SWORN AND SUBSCRIBED to before me this _____

day of _____, 191 _____, President.

SEAL OF OFFICE TAKING AFFIDAVIT. _____
 (Official capacity) _____, Treasurer.

Note A.—Gross income shall consist of the total of the gross revenues derived from the operation and management of its business and properties, together with all amounts of income from other sources, including dividends received on stock of other corporations, whether subject to this tax or not, and interest received upon obligations of a State or political subdivision thereof, and upon the obligations of the United States or its possessions, as shown by entries upon its books during the year for which the return is made.

Note B.—The deductions authorized shall include all expense items under the various heads acknowledged as liabilities by the corporation making the return and entered on its books during the year. Amounts of income expended in paying dividends on stock, preferred or common, or in making permanent improvements on real estate acquired, or used by a corporation may be deducted in item 4, if the interest is paid, as a rental or franchise charge payment of which is required to be made as a condition to the continued use and possession of the property. The amount so paid and included in item 4 should be stated separately under item 4 (b). (See paragraph 12 on reverse of this form.)

INSTRUCTIONS

SPECIAL NOTICE.—THIS FORM, PROPERLY FILLED OUT AND EXECUTED, MUST BE IN THE HANDS OF THE COLLECTOR OF INTERNAL REVENUE FOR THE DISTRICT IN WHICH IS LOCATED THE PRINCIPAL BUSINESS OFFICE OF THE CORPORATION MAKING THE RETURN, ON OR BEFORE MARCH 1, IN CASE THE RETURN IS BASED ON THE CALENDAR YEAR, OR WITHIN 90 DAYS AFTER THE EXPIRATION OF THE FISCAL YEAR IN CASE THE RETURN IS MADE ON THAT BASIS.

FOR FAILURE TO COMPLY WITH THIS PROVISION OF THE LAW, THE AMOUNT OF THE ASSESSMENT IS INCREASED 50 PER CENT AND LIABILITY TO A SPECIFIC PENALTY NOT EXCEEDING \$10,000 IS INCURRED.

1. This return of annual net income should be filed with the Collector of Internal Revenue of the district in which the corporation has its principal place of business.
2. The principal place of business as used in the act and in these regulations is held to mean the place in which the books of account and other data to be used in preparing the return of annual net income are ordinarily kept.
3. Returns must be verified by two officers of the corporation; that is, by two individuals, namely, the president, vice president, or other principal officer, and treasurer or assistant treasurer, or chief financial officer.
4. The affidavit of verification must be made before a notary public or some other officer qualified to administer oaths, and the seal of the attesting officer, if such officer is required by law to have a seal, must be impressed on the return in the space reserved for that purpose.
5. The return must be true and accurate in every respect and must disclose all the income arising, accruing, or received from all sources during the year for which the return is made.
6. If the return is based upon the calendar year it should be filed with the collector on or before the first day of March next succeeding such calendar year. If it is made on the basis of business transacted during a fiscal year, duly designated in accordance with the law and the regulations, the return must be filed with the collector on or before the last-day of the 90-day period next following the date designated as the close of the fiscal year.
7. In case of sickness or absence of an officer required to verify the return, the collector of the district is authorized to extend the time for filing such return not exceeding 30 days from the date when such return is otherwise due. Application for such extension should be made prior to the date when the return is due, or within the 90-day period for which such extension is desired and can be granted.
8. Item No. 1 of the schedule on the obverse of this form should not include unissued or treasury stock, but only such stock as has actually been issued and for which payment has been received; or, in case no stock is issued, there should be reported under this item the amount of capital actually employed in the business and property of the corporation. In case wherein the capital stock is issued payable in installments or upon assessment, only so much of the capital as has been actually paid in upon such installments or assessments should be reported under this item.
9. Item No. 2 should include all interest-bearing indebtedness due the payment of which the corporation or its property is bound. In case of banking corporations and like financial institutions, deposits should not be reported as indebtedness under this item.
10. Item No. 3 of the return from (gross income) should include all income derived from the operations and management of the business and properties, together with all actual increases in value by appreciation, adjustment, or otherwise in the value of the assets which have been taken up on the books as income or credited to profit and loss during the year. In the case of a corporation organized, authorized, or existing under the laws of any foreign country, the gross income to be returned is the gross amount of its income for the year resulting from business transacted and capital invested within the United States.
11. Item No. 4 (a) should include the total amount of all ordinary and necessary expenses paid out of earnings in the maintenance and operation of the business and properties of the corporation, etc., exclusive of interest and other payments to be listed under their respective heads on the return form.
12. Item No. 4 (b) should include all rentals or other payments required to be made as a condition to the continued use or possession of the property. In case wherein interest on a mortgage on property occupied or used by the corporation is paid as a condition to its possession and use, then, becoming in the nature of a rental charge, such interest charge may be included in the deduction under this item. Mortgage indebtedness, assumed or unassumed, on property to which the corporation has taken or is taking title, or in which it has an equity, or in the acquisition of which the mortgage was considered a part of the purchase price, is held to be a debt of the corporation and interest paid on such indebtedness will be deductible only under Item 5 of the return.
13. The amount claimed under Item No. 5 (b) for depreciation should be such an amount as measures the loss which the corporation actually sustains during the year in the value of buildings, machinery, and such other property as is subject to depreciation on account of wear and tear, exhaustion, or obsolescence.

- The amount taken credit for on this account in order to be allowable should be entered on the books as to constitute a liability against the assets of the corporation. The amount claimed under this item should not cover losses in the value of stocks and bonds. Decreases in the book value of securities owned, so far as such decreases represent a decline in the actual value of such securities, should be deducted under Item 5 (a) of the return.
14. Where depreciation of physical property is made good by renewals, replacements, repairs, etc., and the expense of such renewals, replacements, repairs, etc., is charged to the general expense account, no deduction for depreciation can be made in the return of annual net income. Where a depreciation reserve is set up, all renewals and replacements must be charged to such reserve and the addition to this reserve each year must be a like measure of the loss which the corporation sustains by reason of the depreciation of its property.
15. The amount of interest deductible is the amount of interest accrued and paid within the year on bonded or other indebtedness not exceeding one-half of the sum of interest-bearing indebtedness and the paid-up capital stock outstanding at the close of the year, or if no capital stock, the amount of interest paid within the year on an amount of indebtedness not exceeding the amount of capital employed in the business at the close of the year; or in case of a corporation, joint stock company or association, or insurance company organized under the laws of a foreign country, interest so paid on its bonded or other indebtedness to an amount of such bonded or other indebtedness not exceeding the proportion of its paid-up capital stock outstanding at the close of the year, or if no capital stock, the amount of capital employed in the business at the close of the year, which the gross amount of its income for the year from business transacted and capital invested within the United States bears to the gross amount of its income for the year from all sources within and without the United States. All interest deductions must be claimed under Item 4 on the return form.
16. Dividends declared or paid are not deductible from gross income.
17. Dividends received upon the stock of other corporations must be included in gross income and are not deductible therefrom in the ascertainment of the net income on which the tax is computed.
18. Interest received upon the obligations of a State of any political subdivision thereof, and upon the obligations of the United States or its possessions, should be included in gross income, as well as all other interest due and accrued during the period for which the return is made.
19. Accrued interest is considered to be interest due and payable, except in the case of banking or other similar institutions which close their accounts on the basis of the interest earned. In all cases the accrued interest shall be reported on the basis on which the books are closed.
20. Taxes deductible in the return are such taxes, actually paid within the year, as are imposed by authority of the United States or of any State or Territory thereof, or by the government of any foreign country, not including taxes paid by a corporation, pursuant to guaranty, on its bonds or the income therefrom and not including those taxes assessed against local benefits. A reserve for taxes, as such, is not deductible.
21. The gross income of mercantile corporations should be ascertained in the following manner: From the sum of the total sales during the year plus the sum of the inventory at the end of the year, deduct the sum of the inventory at the beginning of the year plus the cost of the goods and materials purchased during the year; to this difference add the income received from any other source and the result will be the gross income to be reported under Item No. 3 of the return.
22. Gross income in the case of a manufacturing corporation shall include the total receipts from the sale of all manufactured goods sold during the year plus any increase in the inventoried value ascertained through an account of the finished and unfinished product, raw material, etc., on hand at the close of the year.
23. To the income thus ascertained there should be added the income arising, accruing, or received from any and all other sources, the aggregate thus ascertained to be the gross income to be returned under Item No. 3 of the return form. Since the gross income thus ascertained represents the total receipts as well as the inventoried value of finished and unfinished products, raw material, etc., the corporation will include in its deduction under Item No. 4 all expenditures for material, labor, fuel, and other items going to make up the cost of the goods sold or inventoried at the end of the year.

SPECIAL NOTICE.—ANY OFFICER OF ANY CORPORATION REQUIRED BY LAW TO MAKE, RENDER, SIGN OR VERIFY ANY RETURN, WHO MAKES ANY FALSE OR FRAUDULENT RETURN OR STATEMENT WITH INTENT TO DEFEAT OR EVADE THE ASSESSMENT REQUIRED BY SECTION 5, ACT OF OCTOBER 3, 1917, TO BE MADE, SHALL BE GUILTY OF A MISDEMEANOR AND SHALL BE FINED NOT EXCEEDING \$2,000, OR BE IMPRISONED NOT EXCEEDING ONE YEAR, OR BOTH, AT THE DISCRETION OF THE COURT, WITH THE COSTS OF PROSECUTION.

Income Tax Department

TO BE FILLED IN BY COLLECTOR.

Form 1040.

TO BE FILLED IN BY INTERNAL REVENUE BUREAU.

INCOME TAX.

List No. _____ File No. _____

District of _____ Assessment List _____

Date received _____ Page _____ Line _____

THE PENALTY FOR FAILURE TO HAVE THIS RETURN IN THE HANDS OF THE COLLECTOR OF INTERNAL REVENUE ON OR BEFORE MARCH 1 IS \$20 TO \$1,000.
(SEE INSTRUCTIONS ON PAGE 4.)

UNITED STATES INTERNAL REVENUE.

RETURN OF ANNUAL NET INCOME OF INDIVIDUALS.

(As provided by Act of Congress, approved October 3, 1917.)

RETURN OF NET INCOME RECEIVED OR ACCRUED DURING THE YEAR ENDED DECEMBER 31, 191____

(FOR THE YEAR 1915, FROM MARCH 1, TO DECEMBER 31.)

Filed by (or for) _____ of _____
(Full name of individual.) (Street and No.)

In the City, Town, or Post Office of _____ State of _____
(Fill in pages 2 and 3 before making entries below.)

| | | | | | |
|--|----|--|--|--|--|
| 1. GROSS INCOME (see page 2, line 12) | \$ | | | | |
| 2. GENERAL DEDUCTIONS (see page 2, line 7) | \$ | | | | |
| 3. NET INCOME | \$ | | | | |
| Deductions and exemptions allowed in computing income subject to the normal tax of 1 per cent. | | | | | |
| 4. Dividends and net earnings received or accrued, of corporations, etc., subject to like tax. (See page 2, line 11) | \$ | | | | |
| 5. Amount of income on which the normal tax has been deducted and withheld at the source. (See page 2, line 9, column A) | | | | | |
| 6. Specific exemption of \$3,000 or \$4,000, as the case may be. (See Instructions 3 and 10) | | | | | |
| Total deductions and exemptions. (Items 4, 5, and 6) | \$ | | | | |
| 7. TAXABLE INCOME on which the normal tax of 1 per cent is to be calculated. (See Instruction 5) | \$ | | | | |

8. When the net income shown above on line 3 exceeds \$20,000, the additional tax thereon must be calculated as per schedule below:

| | | INCOME. | | | | TAX. | | | |
|--|---|---------|--|--|--|------|--|--|--|
| 1 | per cent on amount over \$20,000 and not exceeding \$50,000 | \$ | | | | \$ | | | |
| 2 | " " 50,000 " " 75,000 | | | | | | | | |
| 3 | " " 75,000 " " 100,000 | | | | | | | | |
| 4 | " " 100,000 " " 250,000 | | | | | | | | |
| 5 | " " 250,000 " " 500,000 | | | | | | | | |
| 6 | " " 500,000 | | | | | | | | |
| Total additional or super tax | | \$ | | | | \$ | | | |
| Total normal tax (1 per cent of amount entered on line 7) .. | | \$ | | | | \$ | | | |
| Total tax liability | | \$ | | | | \$ | | | |

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GROSS INCOME.

This statement must show in the proper spaces the entire amount of gains, profits, and income received by or accrued to the individual from all sources during the year specified on page 1.

| DESCRIPTION OF INCOME. | A. | | | | B. | | | |
|--|---|--|--|--|---|--|--|--|
| | Amount of income on which tax has been deducted and withheld at the source. | | | | Amount of income on which tax has not been deducted and withheld at the source. | | | |
| 1. Total amount derived from salaries, wages, or compensation for personal services of whatever kind and in whatever form paid. | \$ | | | | \$ | | | |
| 2. Total amount derived from professions, vocations, businesses, trade, commerce, or sales or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, including bonds, stocks, etc. | | | | | | | | |
| 3. Total amount derived from rents and from interest on notes, mortgages, and securities (other than reported on lines 6 and 7). | | | | | | | | |
| 4. Total amount of gains and profits derived from partnership business, whether the same be divided and distributed or not. | | | | | | | | |
| 5. Total amount of fixed and determinable annual gains, profits, and income derived from interest upon bonds and mortgages or deeds of trust, or other similar obligations of corporations, joint-stock companies or associations, and insurance companies, whether payable annually or at shorter or longer periods. | | | | | | | | |
| 6. Total amount of income derived from coupons, checks, or bills of exchange for or in payment of interest upon bonds issued in foreign countries and upon foreign mortgages or like obligations (not payable in the United States), and also from coupons, checks, or bills of exchange for or in payment of any dividends upon the stock or interest upon the obligations of foreign corporations, associations, and insurance companies engaged in business in foreign countries. | | | | | | | | |
| 7. Total amount of income received from fiduciaries. | | | | | | | | |
| 8. Total amount of income derived from any source whatever, not specified or entered elsewhere on this page. | | | | | | | | |
| 9. TOTALS. | \$ | | | | \$ | | | |
| NOTE.—Enter total of Column A on line 5 of first page. | | | | | | | | |
| 10. AGGREGATE TOTALS OF COLUMNS A AND B | | | | | \$ | | | |
| 11. Total amount of income derived from dividends on the stock or from the net earnings of corporations, joint-stock companies, associations, or insurance companies subject to like tax. (To be entered on line 4 of first page.) | | | | | \$ | | | |
| 12. Total "Gross Income" (to be entered on line 1 of first page) | | | | | \$ | | | |

Income Tax Department

3

GENERAL DEDUCTIONS.

| | | | | | |
|---|---|--|--|--|--|
| 1. The amount of necessary expenses actually paid in carrying on business; but not including business expenses of partnerships, and not including personal, living, or family expenses..... | 6 | | | | |
| 2. All interest paid within the year on personal indebtedness of taxpayer..... | | | | | |
| 3. All national, State, county, school, and municipal taxes paid within the year (not including those assessed against local benefits)..... | | | | | |
| 4. Losses actually sustained during the year incurred in trade or arising from fire, storms, or shipwreck, and not compensated for by insurance or otherwise..... | | | | | |
| 5. Debts due which have been actually ascertained to be worthless and which have been charged off within the year..... | | | | | |
| 6. Amount representing a reasonable allowance for the exhaustion, wear, and tear of property arising out of its use or employment in the business, not to exceed, in the case of mines, 5 per cent of the gross value at the mine of the output for the year for which the computation is made, but no deduction shall be made for any amount of expense of restoring property or making good the exhaustion thereof, for which an allowance is or has been made..... | | | | | |
| 7. Total "GENERAL DEDUCTIONS" (to be entered on line 2 of first page)..... | | | | | |

AFFIDAVIT TO BE EXECUTED BY INDIVIDUAL MAKING HIS OWN RETURN.

I solemnly swear (or affirm) that the foregoing return, to the best of my knowledge and belief, contains a true and complete statement of all gains, profits, and income received by or accrued to me during the year for which the return is made, and that I am entitled to all the deductions and exemptions entered or claimed therein, under the Federal Income-tax Law of October 3, 1913.

Sworn to and subscribed before me this

day of, 191

(Signature of individual)



.....

 (Official capacity.)

AFFIDAVIT TO BE EXECUTED BY DULY AUTHORIZED AGENT MAKING RETURN FOR INDIVIDUAL.

I solemnly swear (or affirm) that I have sufficient knowledge of the affairs and property of to enable me to make a full and complete return thereof, and that the foregoing return, to the best of my knowledge and belief, contains a true and complete statement of all gains, profits, and income received by or accrued to said individual during the year for which the return is made, and that the said individual is entitled, under the Federal Income-tax Law of October 3, 1913, to all the deductions and exemptions entered or claimed therein.

Sworn to and subscribed before me this

day of, 191

(Signature of agent.)



.....

 (Official capacity.)

ADDRESS
IN FULL

.....

* 7-125

[SEE INSTRUCTIONS ON BACK OF THIS PAGE.]

INSTRUCTIONS.

1. This return shall be made by every citizen of the United States, whether residing at home or abroad, and by every person residing in the United States, though not a citizen thereof, having a net income of \$3,000 or over for the taxable year, and also by every nonresident alien deriving income from property owned and business, trade, or profession carried on in the United States by him.

2. When an individual by reason of minority, sickness or other disability, or absence from the United States, is unable to make his own return, it may be made for him by his duly authorized representative.

3. The normal tax of 1 per cent shall be assessed on the total net income less the specific exemption of \$3,000 or \$4,000 as the case may be. (For the year 1913, the specific exemption allowable is \$2,500 or \$3,333.33, as the case may be.) If, however, the normal tax has been deducted and withheld on any part of the income at the source, or if any part of the income is received as dividends upon the stock or from the net earnings of any corporation, etc., which is taxable upon its net income, such income shall be deducted from the individual's total net income for the purpose of calculating the amount of income on which the individual is liable for the normal tax of 1 per cent by virtue of this return. (See page 1, line 7.)

4. The additional or super tax shall be calculated as stated on page 1.

5. This return shall be filed with the Collector of Internal Revenue for the district in which the individual resides if he has no other place of business, otherwise in the district in which he has his principal place of business; or in case the person resides in a foreign country, then, with the collector for the district in which his principal business is carried on in the United States.

6. This return must be filed on or before the first day of March succeeding the close of the calendar year for which return is made.

7. The penalty for failure to file the return within the time specified by law is \$20 to \$1,000. In case of refusal or neglect to render the return within the required time (except in cases of sickness or absence), 50 per cent shall be added to amount of tax assessed. In case of false or fraudulent return, 100 per cent shall be added to such tax, and any person required by law to make, render, sign, or verify any return who makes any false or fraudulent return or statement with intent to defraud or evade the assessment required by this section to be made shall be guilty of a misdemeanor, and shall be fined not exceeding \$2,000 or be imprisoned not exceeding one year, or both, at the discretion of the court, with the costs of prosecution.

8. When the return is not filed within the required time by reason of sickness or absence of the individual, an extension of time, not exceeding 30 days from March 1, within which to file such return, may be granted by the collector, provided an application therefor is made by the individual within the period for which such extension is desired.

9. This return properly filled out must be made under oath or affirmation. Affidavits may be made before any officer authorized by law to administer oaths. If before a justice of the peace or magistrate, not using a seal, a certificate of the clerk of the court as to the authority of such officer to administer oaths should be attached to the return.

10. Expenses for medical attendance, store accounts, family supplies, wages of domestic servants, cost of board, room, or house rent for family or personal use, are not expenses that can be deducted from gross income. In case an individual owns his own residence he can not deduct the estimated value of his rent,

neither shall he be required, to include such estimated rental of his home as income.

11. The farmer, in computing the net income from his farm for his annual return, shall include all moneys received for produce and animals sold, and for the wool and hides of animals slaughtered, provided such wool and hides are sold, and he shall deduct therefrom the sums actually paid as purchase money for the animals sold or slaughtered during the year.

When animals were raised by the owner and are sold or slaughtered he shall not deduct their value as expenses or loss. He may deduct the amount of money actually paid as expenses for producing any farm products, live stock, etc. In deducting expenses for repairs on farm property the amount deducted must not exceed the amount actually expended for such repairs during the year for which the return is made. (See page 3, item 6.) The cost of replacing tools or machinery is a deductible expense to the extent that the cost of the new articles does not exceed the value of the old.

12. In calculating losses, only such losses as shall have been actually sustained and the amount of which has been definitely ascertained during the year covered by the return can be deducted.

13. Persons receiving fees or emoluments for professional or other services, as in the case of physicians or lawyers, should include all actual receipts for services rendered, in the year for which return is made, together with all unpaid accounts, charges for services, or contingent income due for that year, if good and collectible.

14. Debts which were contracted during the year for which return is made, but found in said year to be worthless, may be deducted from gross income for said year, but such debts can not be regarded as worthless until after legal proceedings to recover the same have proved fruitless, or it clearly appears that the debtor is insolvent. If debts contracted prior to the year for which return is made were included as income in return for year in which said debts were contracted, and such debts shall subsequently prove to be worthless, they may be deducted under the head of losses in the return for the year in which such debts were charged off as worthless.

15. Amounts due or accrued to the individual members of a partnership from the net earnings of the partnership, whether apportioned and distributed or not, shall be included in the annual return of the individual.

16. United States pensions shall be included as income.

17. Estimated advance in value of real estate is not required to be reported as income, unless the increased value is taken up on the books of the individual as an increase of assets.

18. Costs of suits and other legal proceedings arising from ordinary business may be treated as an expense of such business, and may be deducted from gross income for the year in which such costs were paid.

19. An unmarried individual or a married individual not living with wife or husband shall be allowed an exemption of \$3,000. When husband and wife live together they shall be allowed jointly a total exemption of only \$4,000 on their aggregate income. They may make a joint return, both subscribing thereto, or if they have separate incomes, they may make separate returns; but in no case shall they jointly claim more than \$4,000 exemption on their aggregate income.

20. In computing net income there shall be excluded the compensation of all officers and employees of a State or any political subdivision thereof, except when such compensation is paid by the United States Government.

• 2-727

Income Tax Department

Form 1041.

TO BE FILLED IN BY APPLICANT, INCLUDING SIGNATURE

INCOME TAX.

File No. _____

**THE PENALTY
FOR FAILURE TO HAVE THIS RETURN IN
THE HANDS OF THE COLLECTOR OF
INTERNAL REVENUE ON OR BEFORE
MARCH 1 IS \$20 TO \$1,000.
(SEE INSTRUCTIONS ON PAGE 4.)**

Assessment List

Page _____ Line _____

UNITED STATES INTERNAL REVENUE.

RETURN OF ANNUAL INCOME BY FIDUCIARIES.

(As provided by Act of Congress approved October 3, 1913.)

RETURN OF INCOME RECEIVED OR ACCRUED DURING THE YEAR ENDED DECEMBER 31, 1921____

(FOR THE YEAR 1913, FROM MARCH 1, TO DECEMBER 31.)

Filed by _____, acting in the capacity of _____

(Name of Ministry.)

_____, for the beneficiaries of the estate or trust of _____

(State whether trustee, executor, etc.)

(Fill in pages 2 and 3 before making entries on this page.)

| | | | | | |
|---|----|--|--|--|--|
| 1. GROSS INCOME (see page 2, line 11) | \$ | | | | |
| 2. TOTAL DEDUCTIONS (see page 2, line 9) | \$ | | | | |
| 3. Amount of income paid or payable to beneficiaries on which the normal tax of 1 per cent has been deducted and withheld as listed below | \$ | | | | |

[illegible]

The Journal of Accountancy

GROSS INCOME.

This statement must show in the proper spaces the entire amount of gains, profits, and income coming into the custody or control and management of the fiduciary, for the benefit of the beneficiaries of the trust or estate, during the year specified on page 1.

| DESCRIPTION OF INCOME. | A. Amount of income on which tax has been deducted and withheld at the source. | | | | B. Amount of income on which tax has been deducted and withheld at the source. | | | |
|--|---|--|--|--|---|--|--|--|
| 1. Total amount derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid. | \$ | | | | \$ | | | |
| 2. Total amount derived from professions, vocations, businesses, trade, commerce, or sales or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, including bonds, stocks, etc. | | | | | | | | |
| 3. Total amount derived from rents and from interest on notes, mortgages, and securities (other than reported on lines 5 and 6). | | | | | | | | |
| 4. Total amount of gains and profits derived from partnership business, whether the same be divided and distributed or not. | | | | | | | | |
| 5. Total amount of fixed and determinable annual gains, profits, and income derived from interest upon bonds and mortgages or deeds of trust, or other similar obligations of corporations, joint-stock companies or associations, and insurance companies, whether payable annually or at shorter or longer periods. | | | | | | | | |
| 6. Total amount of income derived from coupons, checks, or bills of exchange for or in payment of interest upon bonds issued in foreign countries and upon foreign mortgages or like obligations (not payable in the United States), and also from coupons, checks, or bills of exchange for or in payment of any dividends upon the stock or interest upon the obligations of foreign corporations, associations, and insurance companies engaged in business in foreign countries. | | | | | | | | |
| 7. Total amount of income derived from any source whatever, not specified or entered elsewhere on this page. | | | | | | | | |
| 8. TOTALS | \$ | | | | \$ | | | |
| NOTE—Enter total of Column A on line 8 of third page. | | | | | | | | |
| 9. AGGREGATE TOTALS OF COLUMNS A AND B | | | | | \$ | | | |
| 10. Total amount of income derived from dividends on the stock or from the net earnings of corporations, joint-stock companies, associations, or insurance companies subject to like tax (To be entered on line 7 of third page.) | | | | | \$ | | | |
| 11. AGGREGATE TOTAL OF "Gross Income" (to be entered on line 1 of first page) | | | | | \$ | | | |

c 9-7374

Income Tax Department

8

DEDUCTIONS.

| | | | | |
|---|----|--|--|--|
| 1. The amount of necessary expenses actually paid in carrying on business, but not including business expenses of partnerships, and not including personal, living, or family expenses..... | \$ | | | |
| 2. All interest paid within the year on personal indebtedness of taxpayer..... | | | | |
| 3. All United States, State, county, school, and municipal taxes paid within the year (not including those assessed against local benefits)..... | | | | |
| 4. Losses actually sustained during the year incurred in trade or arising from fire, storms, or shipwreck, and not compensated for by insurance or otherwise..... | | | | |
| 5. Debts due which have been actually ascertained to be worthless and which have been charged off within the year..... | | | | |
| 6. Amount representing a reasonable allowance for the exhaustion, wear, and tear of property arising out of its use or employment in the business, not to exceed, in the case of mines, 5 per cent of the gross value at the mine of the output for the year for which the computation is made, but no deduction shall be made for any amount of expense of restoring property or making good the exhaustion thereof, for which an allowance is or has been made..... | | | | |
| 7. Total amount of income derived from dividends on the stock or from the net earnings of corporations, joint-stock companies, associations, or insurance companies subject to like tax (same as entry on line 10, page 2)..... | | | | |
| 8. Amount of income on which the normal tax of 1 per cent has been deducted and withheld at the source (see page 2, line 8, column A)..... | | | | |
| 9. TOTAL DEDUCTIONS (to be entered on line 8 of first page)..... | \$ | | | |

AFFIDAVIT TO BE EXECUTED WHERE FIDUCIARY IS AN INDIVIDUAL.

I solemnly swear (or affirm) that I am the _____ for the beneficiaries of the estate or (State whether trustee, executor, etc.)

trust of _____, that the foregoing return, to the best of my knowledge and belief, contains a true and complete statement of all gains, profits, and income coming into my custody or control and management during the year for which the return is made; that said beneficiaries are entitled, under the Federal Income-tax Law of October 3, 1913, to all the deductions entered or claimed therein; that all certificates claiming personal exemption, presented by the beneficiaries, are herewith inclosed; and there is contained therein a true and complete list of the names and addresses of all beneficiaries to whom any part of the amount stated on line 8 of the first page thereof has been paid or is payable.

Sworn to and subscribed before me this _____

(Signature of fiduciary.)

day of _____, 191

ADDRESS
IN FULL

SEAL OF
OFFICER
TAKING
AFFIDAVIT.

AFFIDAVIT TO BE EXECUTED WHERE FIDUCIARY IS AN ORGANIZATION.

I solemnly swear (or affirm) that I am the _____ of the _____ (State official position.) (State name of fiduciary organization.)

of _____, which organization is the duly authorized or appointed _____ (Address in full.) (State whether trustee, executor, etc.)

for the beneficiaries of the estate or trust of _____, that I am duly authorized to act for said fiduciary; that the foregoing return, to the best of my knowledge and belief, contains a true and complete statement of all gains, profits, and income coming into the custody or control and management of said organization in its fiduciary capacity as stated during the year for which the return is made; that said beneficiaries are entitled under the Federal Income-tax Law of October 3, 1913, to all the deductions entered or claimed therein; that all certificates claiming personal exemption, presented by the beneficiaries, are herewith inclosed; and there is contained therein a true and complete list of the names and addresses of all beneficiaries to whom any part of the amount stated on line 8 of the first page thereof has been paid or is payable.

Sworn to and subscribed before me this _____

(Signature of officer representing fiduciary.)

day of _____, 191

ADDRESS
IN FULL

SEAL OF
OFFICER
TAKING
AFFIDAVIT.

INSTRUCTIONS.

1. Fiduciaries shall, when the annual interest of any beneficiary in income accruing and payable through said fiduciary is in excess of \$3,000, make and render a return on this form of such income of the person or persons for whom they act, to the Collector of Internal Revenue of the district in which the fiduciary resides. The return shall be made as provided herein, whether the income is distributed or not. See Treasury Decision 1904.

2. The list return required from fiduciaries by regulations provided in Treasury Decision 1904, issued November 28, 1913, shall be made on page 1 of this return, giving thereon the name of each beneficiary of the trust or estate, the amount of income paid or accrued to each beneficiary, the amount of exemption claimed by each beneficiary, if any, the amount of income on which fiduciary is liable for tax, and the amount of income withheld for tax.

3. Where several individuals act jointly in a fiduciary capacity, when this return is required it may be made and executed by one of two or more. When the fiduciary is an organization it shall be signed and executed by the President, Secretary, or Treasurer of said organization.

4. This return shall be filed with the Collector of Internal Revenue for the district in which the fiduciary resides if he has no other place of business, otherwise in the district in which he has his principal place of business.

5. This return must be filed on or before the first day of March succeeding the close of the calendar year for which return is made.

6. The penalty for failure to file the return within the time specified by law is \$50 to \$1,000. In case of refusal or neglect to render the return within the required time (except in case of sickness or absence) 50 per cent shall be added to amount of tax assessed. In case of false or fraudulent return 100 per cent shall be added to such tax and a fine not exceeding \$2,000 or imprisonment not exceeding one year or both may be imposed.

7. When the return is not filed within the required time by reason of sickness or absence of the fiduciary, an extension of time not exceeding 30 days from March 1, within which to file such return may be granted by the Collector, provided an application therefor is made by the fiduciary within the period for which such extension is desired.

8. This return properly filled out must be made under oath or affirmation. Affidavits may be made before any officer authorized by law to administer oaths. If before a justice of the peace or magistrate, not using a seal, a certificate of the clerk of the court as to the authority of such officer to administer oaths should be attached to the return.

The following instructions, so far as applicable, are to be considered by the fiduciary in determining the amount of income coming into his custody or control and management which should be reported in this return on page 2, and the deductions which should be reported on page 3.

9. Expense for medical attendance, store accounts, family supplies, wages of domestic servants, cost of board, room, or house rent for family or personal use, are not expenses that can be deducted from gross income. In case an individual owns his own residence he can not deduct the estimated value of his rent, neither shall he be required to include such estimated rental of his home as income.

10. The farmer, in computing the net income from his farm for his annual return, shall include all moneys received for pasture and animals sold, and for the wool and hides of animals slaughtered, provided such wool and hides are sold, and he shall deduct therefrom the sums actually paid as purchase money for the animals sold or slaughtered during the year.

When animals are raised by the owner and are sold or slaughtered, he shall not deduct their value as expenses or loss. He may deduct the amount of money actually paid as expenses for producing any farm products, live stock, etc. In deducting expenses for repairs on farm property the amount deducted must not exceed the amount actually expended for such repairs during the year for which the return is made. (See page 3, item 6.) The cost of replacing tools or machinery is a deductible expense to the extent that the cost of the new articles does not exceed the value of the old.

11. In calculating losses, only such losses as shall have been actually sustained and the amount of which has been definitely ascertained during the year covered by the return can be deducted.

12. Persons receiving fees or emoluments for professional or other services, as in the case of physicians or lawyers, should include all actual receipts for services rendered in the year for which the return is made, together with all unpaid accounts, charges for services, or contingent income due for that year, if good and collectible.

13. Debts which were contracted during the year for which return is made, but found in said year to be worthless, may be deducted from gross income for said year, but such debts can not be regarded as worthless until after legal proceedings to recover the same have proved fruitless, or it clearly appears that the debtor is insolvent. If debts due to the taxpayer and contracted prior to the year for which return is made were included as income in return for year in which said debts were contracted, and such debts shall subsequently prove to be worthless, they may be deducted under the head of losses in the return for the year in which such debts were charged off as worthless.

14. Amounts due or accrued to the individual members of a partnership from the net earnings of the partnership, whether apportioned and distributed or not, shall be included in the annual return of the individual.

15. United States pensions shall be included as income.

16. Estimated advance in value of real estate is not required to be reported as income, unless the increased value is taken up on the books of the individual as an increase of assets.

17. Costs of suits and other legal proceedings arising from ordinary business may be treated as an expense of such business, and may be deducted from gross income for the year in which such costs were paid.

18. An unmarried individual or a married individual not living with wife or husband shall be allowed an exemption of \$3,000. When husband and wife live together they shall be allowed jointly a total exemption of only \$4,000 on their aggregate income.

19. In computing net income there should be excluded the compensation of all officers and employees of a State or any political subdivision thereof, except when such compensation is paid by the United States Government.

Part 1002

UNITED STATES INTERNAL REVENUE

Filed by _____, License No. _____
(Name of bank or collecting center.)

To be made in duplicate to the Collector of Internal Revenue for the District in which the Homestead is located, on or before the 30th-day of each month, showing the names and addresses of persons who have received payments from coupons, checks, or Bills of exchange representing interest upon bonds issued in foreign countries and upon foreign mortgages or his obligations (not payable in the United States), or dividends upon the stock or interest upon the obligations of foreign corporations, associations, or insurance companies engaged in business in foreign countries, so which the normal tax of one per cent has been deducted and withheld during the preceding month.

I (we), _____ of _____ (State address in full.)
 the _____ of the above-named bank or collecting agency located at _____ (Address in full.)
 do solemnly swear (or affirm) that the following is a true and complete return of all payments as above described, made by said bank or collecting agency, and from which the normal tax of 1 per cent was deducted and withheld at the time of payment, or for which it is liable as withholding agent, during the month of _____, 191_, and there are herewith inclosed all certificates claiming exemption which were presented with said coupons, checks, etc.

[illegible]

To _____
City _____
District of _____
(Address.)

Sworn to and subscribed before me this _____
day of _____, 191 _____

Signed _____
(Place to attach seal.)

Form A—Withholding agents may, if they so desire, pay at the time this list is filed, to the Collector of Internal Revenue with whom the list is filed, the amount of tax withheld during the month for which the list is made.

Form B—All certificates of ownership of collecting agents, authorized by regulations, that are removed by debitors or withholding agents will be considered the same as certificates of ownership, and will be considered identical. Identify the Debtor, debtor, or withholding agent will enter the name, address, and the number of the certificate of ownership of the collector in line of the name and address of the owner of the bonds.

Form C—State "—" for "State," "—" for "District," "—" for "Division," etc., as the case may be.

Students' Department

EDITED BY SKYMOUR WALTON, CHICAGO, ILL.

One of the most difficult things for many persons to understand is the relation of cash income or outgo to the accounting principles involved in any particular case. It is hard for them to get away from the consideration of the cash movement alone, even to the extent of determining the profit or loss from the standpoint of the available cash to be distributed. This is well illustrated in an answer that is frequently given to the following very simple problem.

Bilsom and Marley are partners, sharing profits and losses equally. The partnership is dissolved December 31, 1907, at which time Bilsom's capital investment is \$10,000, and Marley's \$2,500. The total liabilities of the firm are \$25,000, which includes \$5,000 due Bilsom on loan account and \$2,500 due Marley on loan account. The whole of the assets of the firm are disposed of for \$30,000 cash on May 1, 1908. Prepare accounts closing the partnership and show the position in which the partners stand to each other. No allowance for interest is required.

Looking at it entirely from the viewpoint of the money to be disbursed, it is more often than not answered in this way:

| | | |
|---|-------------|----------|
| Total cash realized | \$30,000.00 | |
| Outside liabilities paid | 17,500.00 | |
| Remainder belonging to partners | \$12,500.00 | |
| Bilsom's loan paid | \$5,000.00 | |
| Marley's loan paid | 2,500.00 | 7,500.00 |
| Cash balance to be distributed to capital | \$ 5,000.00 | |

This cash is then given to the partners in the proportion of their original capitals, Bilsom 4-5 or \$4,000 and Marley 1-5 or \$1,000. This leaves Bilsom with a balance in his capital account of \$6,000, and Marley with \$1,000, and there the answer usually stops. Sometimes the accounts of the partners are closed by charging Bilsom with a loss of \$6,000 and Marley with a loss of \$1,000, in spite of the fact that the problem explicitly states that profits and losses are shared equally.

This method of looking at the cash only is probably a survival of the old idea of receipts and disbursements as a proper statement of business transactions. Having so much money to dispose of, the first idea is to disburse it in the way that seems most logical from the information that is then apparently available. As there is no more money with which to pay the capital of the partners, the condition of their accounts must necessarily be correct.

Of course, the flaw in this reasoning is that the distribution of the money does not determine the condition of the partners' capital accounts, but that the condition of the partners' capital accounts determines the dis-

The Journal of Accountancy

tribution of the money. That is, the accounting principle must first be applied of closing the profit and loss account into the capital accounts and then of making the distribution of the money on the basis of the capital accounts as they stand at that time. Without taking the space for an extended formal answer, it is plain that the liquidating loss is \$7,500. Charging this equally to the partners will leave Bilsom with a credit balance of \$6,250 in his capital account, while Marley's capital would be overdrawn \$1,250, to represent the last \$5,000 to be distributed. When this condition became apparent, Bilsom would undoubtedly be justified in claiming that Marley should transfer \$1,250 from his loan to his capital account to cover the deficiency. The rule that loans from partners take precedence of their capital accounts in liquidation would be modified by Bilsom's right to demand a set-off to protect his interests. He could allow Marley to draw out his whole loan and then repay the shortage in his capital; but there would be no use in doing this, even if there were no danger that Marley would refuse to do it on one pretext or another. The proper distribution of the \$12,500.00 left after paying the outside creditors would be:

| | |
|--------------------------------|-------------|
| Bilsom's loan | \$ 5,000.00 |
| Bilsom's capital balance | 6,250.00 |
| Marley's loan balance | 1,250.00 |
| | <hr/> |
| | \$12,500.00 |

It may seem to some that this is too simple a matter to require any serious thought, and that only beginners in accountancy could make such a mistake. So deep-rooted is the habit of treating with the money only that it is safe to say that if this question were given in a C. P. A. examination a good proportion of the answers would be in accordance with that view of it.

WHEN CONFUSION ARISES

A similar confusion arises from the inability of many persons, including some accountants who ought to be better able to discriminate, to see the distinction between a financial requirement to pay for something out of profits and the accounting principle of charging the amount against profits. The accounting principle must govern in every case. The financial requirement has nothing to do with determining whether any part of the amount or the whole of it is to be charged against revenue. This point is clearly illustrated in a problem given in one of the Illinois examinations. It is not necessary to give the problem in full here, as the other principles involved in it are not pertinent to our present subject. It is sufficient to say that a cemetery association, after having developed its property, "commences selling burial lots, and all lots are sold under a special provision whereby the company agrees to apply fifty per cent of all cash received on sales in the purchase of 4% bonds, until a total of \$150,000 of such bonds shall have been so purchased. The agreement further provides that after all lots have been sold the company will

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wind up its affairs, and the above bonds, amounting to \$150,000, shall be given to the city, which shall use the income of such bonds for keeping up the cemetery." At the time the statement is called for by the problem, three-quarters of the lots had been sold for \$350,000 cash, bonds to the amount of \$125,000 had been bought and were on hand, and there was more than enough money in bank to buy the other \$25,000. It is agreed that the remaining one-quarter of the lots are "of equally desirable character with those already sold."

In this case there is no doubt as to the financial requirement—\$150,000 of the \$350,000 realized from lot sales must be used to purchase bonds. It is also true that the whole \$150,000 of the bonds must eventually be charged off against the profits, since their gift to the city will mean a complete loss or expense to the enterprise. Because the agreement requires that all the bonds must be bought out of the first \$300,000 realized from the sales, the conclusion is reached by most of those who answer this problem that the entire \$150,000 must be at once charged against the profits. This view is taken in an answer that has been published. The truth of the matter is that the financial requirement has nothing whatever to do with the accounting principle governing the amount to be charged off.

In the first place, the agreement is not made with the city. It is made with the lot owners. In consideration of a certain amount paid for each lot the cemetery association obligates itself to provide for perpetual care of the lot. As \$150,000 is considered large enough to provide an income sufficient to care for all the lots, the sale price of which will eventually be \$466,666.67, it has evidently been calculated that 31% of the price of each lot will be set aside to provide perpetual care for that lot. Therefore, 69% of the price of each lot is to be credited to Lot Sales, and 31% must be credited to Perpetual Care Reserve. This is the accounting principle, and it must be carried out at the time of each sale, without any regard whatever to the means that may be devised to ensure that the perpetual care will always be given to the lots. There might have been any one of several financial expedients adopted. The purchase of the bonds might have been deferred until the last lot was sold. The bonds might have been put in the hands of a trust company, or in those of an individual trustee, or there might not have been any bonds deposited with any one, if the association had concluded to continue in the management of the property, expecting that it could make enough out of the product of its greenhouses to provide for the care of all the lots and also for a small profit besides. That it agreed to buy the bonds out of the first two-thirds of its gross income and to constitute the city as its trustee in carrying out the obligation to the lot owners, is merely a detail of the financial arrangement that it happened to adopt. As three-quarters of the lots had been sold, three-quarters of the reserve should have been set up, or \$112,500, which is the amount now chargeable against the lot sales, and not \$150,000. Charging the latter amount would make three-quarters of the lots stand the cost of caring for all of them.

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GIVING CORRECT NAMES

Incidentally it may be remarked that the published solution referred to is in error in calling the bonds a sinking fund, instead of giving the fund its correct name of Perpetual Care Fund. A sinking fund is a financial arrangement to secure the prompt payment of an obligation maturing in the future. When the obligation matures the sinking fund is used to pay it off, and both the sinking fund and the obligation disappear from the accounts, having cancelled each other. This fund has no such function. It never disappears, but remains in the possession of the city forever, only the income being used to carry out the purpose for which the fund was established. Another difference is that the income from a sinking fund is usually, if not always, retained in the fund and re-invested.

Again, the reserve that is set up is not a reserve for bonds, still less is it a sinking fund reserve, as the author quoted above calls it. The reserve was not set up to buy bonds, but it was set up for the purpose of providing for the perpetual care of the lots, and is the measure of the cost of that care. Therefore, it is a perpetual care reserve, and the placing of certain bonds in the fund is only an expression of the means adopted to provide for the care.

It may be said that these are exceedingly fine distinctions, and that it does not make much difference what names are given to the fund and the reserve, since the ultimate result is the same; the bonds are given to the city and the reserve is charged against the profits of the enterprise. But if accountancy is to rank as a learned profession, as it certainly should do, it will be because accountants themselves have a clear idea of the real meaning of the terms they use, and are able to give a scientific and logical reason for the way they use them. It may well be asked how the student is to learn correct methods when accountants themselves are as careless as many of the former are. At least we will hope that it is carelessness and not lack of scientific thought on their part.

The same confusion is apparent in the way in which the legal and accounting right to declare a dividend is denied because of a financial inability to pay the dividend in cash. This often leads to the statement that certain profits, arising outside of the routine operations of a company must not be credited to the ordinary surplus, but must be put into an account variously designated as Special Reserve, Special Surplus, Permanent Surplus, or Capital Surplus. The latter term is a favorite with some persons, who seem to forget that surplus is really surplus capital, and that, therefore, the full name of their favorite account should be Capital Surplus Capital.

The accounting principle governing the declaration of a dividend is that it must be based on profits actually made. This means that proper provision must have been made for a reasonable amount of depreciation and for losses from bad debts, and that all accrued expenses must have been put on the books, and that all other precautions have been taken in regard to inventories, consignments, etc. to prevent an overstatement

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of the profits. When the profits have been thus ascertained, the whole of them are available for dividends, both from a legal and an accounting viewpoint.

MATTER OF UNREALIZED PROFITS

While it is true that an unrealized profit must not be allowed to swell the earning power and the assets of a business, it is equally true that a profit that has been realized and that has added real value to the business should be given expression in the account, although it arose from something not strictly in the line of the regular operations of the business. The actual sale of a fixed asset, such as land, for a price greater than its cost, would be a real profit, and there is no reason for treating it as anything else, simply because it was not part of the regular business of the company to sell land. Care must always be exercised that such profits are not allowed to appear as operating profits due to the conduct of the business, and that they are not included in any statement of the average profits of the business as a business. But if they are real profits they form just as legitimate an element of the surplus as do the profits arising from operation.

Those accountants who advise that such accidental or sporadic profits should not be credited to the regular surplus account, but should be put into some special account where it will not be available for dividends fail to say what advantage is to be gained by such a treatment of them. If the profits thus set apart are considered to be of such a peculiar nature that they are not under the control of the board of directors for purposes of dividends, they are clearly wrong, for dividends can be declared out of any unimpaired surplus, however it arose. It is sometimes recommended that the special reserve be charged with future depreciation, but those who take this view do not seem to realize that this is treating it as a real profit, only that it is spread over future years instead of appearing in the year in which it was made. The relieving of future years of the necessity for providing for the expense of depreciation is exactly equivalent to giving those years a share of the profit to which they are not entitled, with the added disadvantage of distributing their record of operating profit and loss by the elimination of the depreciation element, thus causing them to make a proportionately better showing than the previous years, which bore their proper share of the burden of depreciation.

The conclusion seems irresistible that, if a profit is legitimate and real, it belongs in the surplus account, however it may have originated. If the profit is not real, it has no place on the books at all. In the case of a conditional profit, such as when land is donated to a factory under conditions requiring a number of years for their fulfillment, it may be expressed in the accounts by crediting it to an account that specifically shows its unrealized character, such as "Contingent Profit on Land." There would be no danger of mistaking an account thus designated for a real profit, as long as the contingency remained.

Mr. Montgomery says: "It may be that a profit has been realized on

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a sale of a portion of the fixed assets of a concern. Legally this profit may be carried to surplus and distributed as a dividend, but such a course is apt to create a false impression on stockholders. It is much better to carry such an item to an account whose caption indicates the character of the entries therein, and which may be carried on a balance sheet as a separate section of the surplus account. Under such circumstances it will not appear to be applicable to dividend distributions and can be held as a contingent reserve against possible losses on other capital adjustments."

This seems to imply that the directors would declare a dividend out of such profits and make it appear that it arose from the regular operations of the business. This would be open to such serious objections that it should certainly be prevented, if possible. If, however, it was made clear to the stockholders that the dividend was an extra one, made possible by an accidental profit, not likely to be repeated, there seems no reason for depriving the stockholders of the enjoyment of it. After all, it is a matter for the directors to decide, and it would be very unwise of them to deceive the stockholders as to the source of the dividend, and thus lay up for themselves trouble in the future, when similar dividends would not be forthcoming. It would be extremely reprehensible in an auditor if he should so state the accounts as to lead to the impression that the dividend was based on the ordinary operating profit. But if this point is clear, the advisability of paying a dividend is entirely a question of financing, and approaches an accounting principle only to the extent that the necessity for providing an adequate working capital may be called a principle. Even as to that point the directors are supposed to be the best judges.

As to providing a "contingent reserve against possible losses on other capital adjustments," the question is pertinent, why make these possible adjustments contingent on sporadic profits? If they are likely to occur they should be provided against, in any event, by regular charges against revenue and credits to a reserve for contingencies. It would be very unwise for a telephone company or an electric railway company having overhead wires to postpone the establishment of a reserve for such contingencies as a sleet storm until, by some lucky accident, they had made an unexpected profit outside of their operations, with which to set up the reserve. Having adopted the principle of establishing such a reserve as part of their operating cost, they do not need to credit it with an accidental profit, and should not do so, if they intend to relieve future years of the burden of providing their share of the contingent risk, and thus throw their operating statements out of harmony with previous years.

The sum of the whole matter is that, as we have said, the accounting principle governing the declaration of a dividend is the existence of clearly legitimate profits sufficient to cover it. The wisdom of declaring it is entirely a matter for the decision of the directors, with whom the financial consideration will naturally have great weight. They can refuse to declare it at all, if they think the money can be better used as working capital, or they can declare a scrip or a stock dividend. The point

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is, that in making this decision, they are influenced entirely by financial considerations and not by accounting principles.

The only way in which a special or permanent reserve or surplus can be established from which the directors cannot declare dividends, is for the stockholders to establish it, to be subject to their control alone. This they can do with contributed surplus, paid in with the capital, or with any accidental profits that may be made, or by setting apart any portion of the profits made out of regular operations. For a board of directors to set up such a special reserve would have no binding effect whatever, since the next board, or for that matter, the same board may at any time rescind the action and transfer the reserve to surplus, where it would be available for dividends.

Announcements

Michigan Association of Certified Public Accountants

At a meeting of the Michigan Association of Certified Public Accountants held January 14th the following officers were elected for the ensuing year: President, Frederick Wixson; vice-president, George C. Brown; secretary, David Smith; treasurer, W. D. Bonthron.

Ernst & Ernst, certified public accountants, announce the establishment of a St. Louis office, at 1537-38-39, 300 Broadway, Corner Olive Street.

William Gray, C.A., (Scot.) has been admitted as a partner in the firm of Laing & Turner, Winnipeg, Regina.

Messrs. Touche, Niven & Co., 30 Broad Street, New York, have opened a Chicago branch with C. R. Whitworth, A.C.A., C.P.A. as resident manager. Their other branches are Minneapolis, London, Montreal, Toronto, Winnipeg, Vancouver, Batavia and Surabaya, Java.

Ernest H. Dale, certified public accountant, announces that he has opened an office at 903-904 Bailey Building, Philadelphia.

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Treatment of Sinking Funds

BY CHARLES S. LUDLAM, C. P. A.

A sinking fund is usually a fund instituted and invested in such a manner that its gradual accumulations will enable it to meet and wipe out a debt at maturity, and it may be said that all sinking funds, even where they do not relate to the discharge of debt obligations, are based in principle on the proposition of gradual provision and accumulation. Of the many sinking funds instituted and operated in this country perhaps it would not be a far cry to say that the most important are those of the large life insurance companies, usually measured by the item of "insurance reserves" on the liability side of their balance sheets, to the extent of which investments shown on the asset side are in reality sinking funds created for the liquidation of the obligations of the companies upon the maturity of their policies.

While to the student of insurance the theories on which insurance premiums are assessed and the correlated sinking funds to meet maturing policies are built up are of great interest, the subject is of too technical a nature to be dealt with in the scope of this paper. Broadly speaking the company (if a life company) on a basis of the life expectancy of its policy holder, according to which it determines the amount to be received in premiums, seeks to so invest its premiums as to meet the obligation at maturity and to provide for its running expenses and profits. As illustrating in non-technical language the principles to be considered the following may be interesting:

If a man invests \$100 at the rate of 5% per annum he should receive as interest or dividend \$5 each year. If he puts this

money aside he will have \$200 at the end of twenty years. If, however, at the end of the first year he receives his interest of \$5 and invests it immediately his interest at the end of the second year would be \$5.25, and if that also was invested at once his invested capital at the end of the second year would be \$110.25. If he continues this process he will have \$265.33 at the end of twenty years. If he received his interest twice each year and similarly invested it at once he would have \$268.51 at the end of twenty years. If he received his interest four times a year and invested it at once he would have \$270.15 at the end of twenty years; if he received his interest one hundred times a year and could invest it at once he would have \$271.76; if he received his interest every second and invested it at once he would have \$271.828. If the interest could be conceived as being received infinitely often, and instantly invested, we would arrive at a sum representing the investment at the end of twenty years which cannot be expressed exactly in figures no matter to how many decimals we carry it, but which would run: \$271.8281828, etc., which with the decimal point thrown forward two places mathematicians designate by the Greek letter epsilon. Of course in actual practice the matter cannot be carried to such a fine point, but due consideration has to be given to the amount of the obligation to be met at the expiration of an expected time and to the rates at which the premiums received can be safely and promptly invested. If the rate at which money can be safely invested falls below the 5% used in this illustration theoretically the premium rate would be adjusted accordingly; but in practice companies allow a margin wide enough in this respect to enable them to maintain uniform premium rates. It may be mentioned in passing that the principal difference between these insurance companies and the insurance feature of many so-called mutual benefit associations consists in the fact that the former are operated on the sinking fund basis and the latter are not.

But aside from the matter of insurance sinking funds there is, perhaps, a still broader field opened for discussion in the many conditions existing and the opinions expressed regarding the sinking fund mortgage which, when it is of large amount, is usually issued to the public in fractional parts, generally of the denomination of \$1,000 each, called bonds. The sinking fund bond is of infinite variety. Nearly every man (or corpora-

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tion) issuing an obligation that he expects or hopes to be able to liquidate gradually has ideas as to just how such liquidation should be provided for in the terms of the mortgage. The banker called on to sell the bond also always has his ideas as to how the sinking fund provisions should be elaborated or "decorated," so that the highest price may be realized for the security and the rate of interest which he has to offer. And then the lawyer who draws the "deed of trust!" Was there ever a lawyer who didn't have his own ideas as to corporate financing and who didn't as a rule succeed in incorporating some of those ideas into every legal document drawn by him? Hence, as stated, there are many varieties of "sinking fund" bonds; but, speaking generally it may be said that a mortgage on property with sinking fund provisions is security given for a debt under conditions which obligate the mortgagor to gradually reduce or provide for the specific indebtedness covered by the sinking fund mortgage, by making partial payments thereon or on account thereof from time to time prior to the final maturity of the entire obligation.

It will thus be seen that a sinking fund for retiring mortgage bonds, while having the same main purpose as a sinking fund of an insurance company, (the extinguishment of a debt), differs therefrom in that in the former case partial payments can be made from time to time by the purchase or call of the bonds; whereas in the latter case provision has to be made for the full amount of the obligation maturing at an expected date, and accordingly in the former case the matter of investment of interest accretions becomes comparatively of less importance. The mortgage usually provides for these payments to be made to a third party designated as the sinking fund trustee and who may be said to act in that capacity as the joint agent of the mortgagor and the mortgagee. The sinking fund trustee may or may not be the general trustee of the mortgage, although generally one party is selected to act in both capacities.

The man who buys a lot for \$1,000, paying \$10 down and entering into a contract to pay \$10 a month, together with interest, on the unpaid balance for the ensuing ninety-nine months, has adopted the primitive features of the modern sinking fund mortgage, save for one more or less minor detail, namely, a trustee to collect the installments and pay them to the mortgagee; and even in such a case there may be a trustee, but,

the transaction being small and the mortgagee available, the mortgagor usually makes the payments of \$10 a month, and interest, direct to the mortgagee instead of through the intermediary of a trustee. Where the mortgage is of large amount and is split up into many parts (bonds) held by many individuals it is impossible or impracticable, for many reasons, for the mortgagor to pay such installments direct to the mortgagee, (the bond owners), and it is equally impossible or impracticable for the mortgagee to collect such installments, hence the introduction of the trustee to handle or invest the installments as the mutual joint agent of the mortgagor and the mortgagee.

To the sinking fund trustee, under a sinking fund mortgage, the mortgagor from time to time, as may be provided by the terms of the mortgage, makes his partial payments, and the payments so received are usually applied by the trustee, under the provision of the mortgage, in one of three ways: (1) Invested in such income-producing securities as the mortgage provisions may permit, and permitted to accumulate until the date on which the entire obligation becomes due, when the funds are used for the purpose for which created; or, (2) and more frequently, to buy in the open market bonds of the mortgagor of the issue for which the trustee is acting, at a price not in excess of a fixed maximum provided by the terms of the mortgage; or (3) to buy direct from the owners bonds of the mortgagor, of the issue referred to, at a fixed price. Under the last mentioned conditions the specific bonds to be purchased are usually determined by drawing or by lot. The bonds so purchased may be cancelled or may be held in the sinking fund and continue to draw interest until the final cancellation of the entire debt according to the terms of the mortgage.

The accounting requirements of the trustee are simple, his transactions being of a cash nature. Eliminating the question of the expenses incurred by the trustee, which in turn are usually re-collectible from the mortgagor, and also the question of the trustee's fees for services, (also usually paid by the mortgagor), a trustee's accounts are practically those of a banker with a depositor. The mortgagor's account, or the "sinking fund account," is credited with deposits (installment payments made by the mortgagor under the terms of the mortgage) and interest collected, and debited with securities purchased, including bonds

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of the mortgagor redeemed. It is appreciated that income accruing from funds and investments in the trustee's hands might, with propriety and a high regard for accounting technicalities, be taken into his accounts as it accrues, but as a matter of fact this is seldom done, and it is not really important as there is no question of principle involved in this instance. Subsidiary records should be kept by the trustee showing in detail (bond numbers, descriptions, etc.) the securities held in the trust, including bonds of the mortgagor purchased and held uncanceled in the sinking fund and also bonds of the mortgagor redeemed and canceled. The trustee must of course know that payments made by the mortgagor comply with the provisions of the mortgage, but this is more a matter of administration than of accounting.

The accounting requirements of the mortgagor are more voluminous than are those of the trustee, but these will be found almost equally simple if the following features are kept in mind:

1—The trustee of the sinking fund, from the point of view now before us, is in effect merely the agent of the mortgagor.

2—Any expense incurred by the trustee under the trust is an expense of the mortgagor.

3—Any payment made by the mortgagor to the trustee, under the provisions of the mortgage, applicable to the retirement of the debt of the mortgagor, is merely a transfer by the mortgagor from one depository to another depository.

4—Any investment made by the trustee of the funds in his hands is an investment of the mortgagor.

5—Any income accruing on funds or securities in the hands of the trustee, under the trust, is income of the mortgagor, and should be taken into the accounts of the mortgagor as it accrues.

6—Any bonds of the mortgagor, redeemed and canceled through the operations of the trustee, reduce the indebtedness of the mortgagor by the amount of the par value thereof.

7—Any bonds of this issue of the mortgagor purchased by the trustee and held as investments of the sinking fund, (although for purposes of ledger record, any bonds so held may be carried in a separate account and not charged directly against the liability account until the bonds are canceled), reduce the

outstanding indebtedness of the mortgagor by the amount of the par value thereof.

8—Any premium paid by the trustee in the purchase of bonds of the mortgagor for redemption is an expense or loss of the mortgagor.

9—Any discount below par at which the trustee may buy bonds of the mortgagor for redemption is a gain or profit to the mortgagor.

It is appreciated that some of our legal friends will claim that bonds of a mortgagor, of the issue covered by a sinking fund purchased by the sinking fund trustee and not retired and canceled, will not reduce the obligation of the mortgagor and that such bonds should be treated as a part of the sinking fund and shown on the balance sheet of a corporation as an asset, and that contra thereto the full amount of the bonds, both outstanding and in the sinking fund, should be shown as a liability. It is admitted that there are some legal reasons for this, the chief of which is perhaps the question of the legal practice in regard to the burden of proof, but it seems to me that questions of this nature would arise only in cases of receivership or liquidation and would have to be dealt with only under court orders, consequently they would not apply to the ordinary accounting of a going concern.

Further, while accountants must be mindful of any and all legal obligations and of any legal situation affecting the accounts of clients, it will be apparent at once to anyone who gives the matter thought that as an actual fact an individual cannot owe money to himself. It would not be logical in its final premise for an individual to undertake to swell both his assets and liabilities by issuing notes to himself, and consequently it is illogical for an individual to show on the one hand as an asset bonds of his own issue which are held by his own trustee for his account, and on the other side of his balance sheet as a liability the identical obligations.

Now, if the nine premises previously mentioned are the salient features of a sinking fund operated through a trustee, it would appear that payments thereto on account of principal made by the mortgagor have no effect on the income of the mortgagor; nevertheless, a few years ago an industrial company was the subject of considerable criticism for the reason that its report

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did not show as charges against the income of the company the payments which it was obliged to make to a sinking fund under the provisions of a deed of trust securing its first-mortgage bonds.

As illustrating the different points of view which may be held as to what effect sinking fund requirements and transactions have on the operation of a company it is interesting to outline and analyze these criticisms. It should be said that the company referred to had some long-term notes outstanding which were of course subordinate in lien to the mortgage. The final results of the company's operations showed a deficit after charging against its income the interest on both bonds and notes outstanding. It was claimed that not only the sinking fund should be deducted from the income of the company but that such deduction should be made prior to charging against the income the interest on the notes, on the ground that such an arrangement of the income account would show that the bonds, both as to interest and sinking fund, were amply protected although the interest on the notes was not being earned. The arguments advanced were:

(1) That according to the terms of the mortgage the bonds had a prior lien on the property and income, and that default such as the non-payment of interest, sinking fund, etc., might bring about the foreclosure and sale of the property, in which case the proceeds would be applied to the bonds before taking care of the notes.

(2) That the mortgage antedated the creation of the indenture under which the notes were issued—the notes therefore necessarily recognized the prior obligations of the company.

(3) That in some previous years the company had clearly established the priority of the sinking fund requirements by meeting the same although it had deferred payment of the interest on the notes.

(4) That it was not sufficient to assert that there was no obligation to pay the sinking fund from income, because the position of the company practically required that it be paid from income; also, that it might be urged with equal force that there was no necessity of paying interest on the notes from income inasmuch as the indenture did not specifically include such provision.

None of the foregoing positions seems to me to be well taken. A bond is in effect merely a secured note or bill payable,

the payment of which is usually fixed for some time in the future. The payment of a loan, whether it be thirty days or thirty years after date, has no relation to the operating or income results of the property so far as the principal of the loan is concerned. In order, however, that the points raised in the criticism referred to may be considered categorically, let us assume:

First: That the bonds referred to are dated January 1, 1900, and are due January 1, 1935.

Second: That the mortgage securing these bonds provides for the gradual liquidation or increased protection of the obligation by annual payments to a sinking fund beginning January 1, 1905, and that the trustee is authorized to use such sinking fund in purchasing the bonds at a price not exceeding \$1,100 per bond and accrued interest; or, in the absence of ability to so purchase, to invest the sinking fund in securities pending the ultimate liquidation of the debt under the terms and conditions of the indenture.

Third: That subject to the various terms and conditions the trustee is to hold all the money investments comprising the sinking fund in trust for the benefit of the mortgagor, its successors or assigns.

Based on the foregoing premises, two things at once become apparent:

(a) The payments made to the sinking fund trustee are:

(1) For the purpose of advancing the liquidation of the company's debt by purchasing its bonds (secured notes) at not exceeding a certain price; or,

(2) In case they cannot be purchased, to add to the security underlying the mortgage by the acquisition of desirable investment securities which would be subject to the lien of the mortgage.

(b) That the trustee of the sinking fund, from the viewpoint of the mortgagor, is merely the agent of the company appointed for the protection of its bondholders to pay off certain of its liabilities or to invest certain of its funds.

Therefore, if and when the payments to the trustee are used by him for the retirement of bonds, the amount of the bonds so retired properly is chargeable to the account on the company's books representing such debt; if and when the money

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paid to the trustee is invested by him in other securities, the company through its agent, the trustee, has made an investment (that is to say, in either case the cash in the company's treasury was reduced by the amount of the payment made to the trustee and the cash in the hands of the trustee temporarily correspondingly increased), then the cash in the hands of the trustee was reduced and at the same time the company's debt reduced or its investments increased. It is apparent that a change in certain of the company's assets or liabilities, *viz.*, a decrease in its cash and a corresponding decrease in its bonded debt or increase in its investments, would not at all affect the statement as to income of the period in which such a transfer happened to be made, much less to the extent of the transfer so made.

There was no provision in the mortgage referred to that the principal of the bonds should be paid out of the income of the company, and it is evident that no such idea was entertained by the directors and stockholders of the company who authorized the mortgage, for the reason that the mortgage was a lien on the property itself and not on its income; that is, it was intended that the property itself should secure the bonds and not the income from the property, as the income was not in any way "tied up" or mortgaged and the property was so "tied up" or mortgaged until the bonds were all paid off. There was nothing in the trust indenture for instance that would prohibit the company from issuing income bonds.

There is no doubt that if the company were in liquidation the holders of the first mortgage bonds would have a prior claim on the assets, but this point has no relation to the question of how the payment of the outstanding liabilities of a going concern should be handled in its accounts. It might as well be claimed that the interest on the bonds should be deducted direct from the gross earnings in the company's income statement and prior to the deduction of the operating expenses as that the sinking fund requirements should be deducted prior to the interest on the outstanding notes, inasmuch as the mortgage obligations were incurred prior to that of the operating expenses, as well as prior to the note interest. In other words it is not a question of where such a charge should be shown in the income account but rather whether or not it should be shown at all.

The fact that in previous years the company paid its sink-

ing fund requirements when it deferred interest on its notes seems to have no relation to the question. Whether the company pays one creditor and defers payment to another creditor would not affect its income account. It must be understood that there is a difference between the incurring and the payment of a liability for an expense. Interest on the notes referred to was charged properly against the income account of the company as it accrued, and the mere question of whether an accrued expense was paid or was not paid would not affect its position in the income account.

The suggestion that owing to the financial condition of the company it was practically necessary that its sinking fund requirements be paid from income, and that it might be urged with equal force that there was no necessity for paying the interest on the notes from income inasmuch as the indenture did not specifically include such a provision, is interesting; but, without regard to the question of whether or not the company had any resources other than its earning capacity from which to pay its obligations, its income account for any year would not be affected by the use of its income for the payment of its debts; that is to say its income account should reflect the result of its operations unaffected by any realizations or liquidations in respect of its capital accounts other than losses or gains therefrom. The payments to the sinking fund, required under the provisions of the first mortgage deed of trust could with entire propriety be made from money borrowed by the company, and indeed in actual practice these are frequently so made. But in any event it must certainly be appreciated that there is a great difference between interest accruing on an outstanding obligation and the payment of the obligation itself. One is an income, the other a capital account.

Such sinking fund payments are in effect merely payments on secured note obligations, but if under any circumstances they could be considered as proper charges against the income account then payments made of any other notes must by the same reasoning be proper charges against the income account; and accordingly, looking at the other side of the account, any receipts from notes issued must be proper credits to the income account. In other words, to any one who so reasons the idea of an income statement must be that of a statement of cash

Treatment of Sinking Funds

receipts and disbursements rather than a statement of earnings accrued and expenses incurred.

Under the rules of the Public Service commission of New York the company referred to was required to provide for the depreciation of its property by monthly charges against its income account, and the amounts represented by these charges were in turn credited to proper reserves and so carried in the accounts of the company. The company would undoubtedly have had a right to use any of the resources represented by these reserves, and not required from year to year, in replacing its property, in meeting its sinking fund payments, or to use any other funds available.

As a believer in publicity and in full information being given to the public as to the financial conditions and requirements of all companies, as well as their operating results, I am in favor of appending to the income statement of any company under obligation to make periodical payments to a sinking fund the amount of such requirements during the period covered by the income statement in order that those interested may have a means of knowing, in a general way, what the fixed requirements of the company are as compared with its operating resources for meeting such requirements. While a statement of the operating results is one thing and a statement of its financial condition or requirements another, and although references from one statement to the other statement may with advantage be presented by the accountant, he should never lose sight of the actual conditions and reasons which would determine the classification of any specific item in the proper one of these two statements.

It has been suggested that in the case of some sinking fund bonds, particularly those of coal companies, the sinking fund provisions are intended to provide for the depreciation of the property and, in that sense, to become a charge against the income account. There is no one who believes more sincerely than I in proper charges being made against the operations of any company for depreciation in its property or other asset accounts which may accrue from period to period; but the questions of sinking fund payments for the retirement of debt obligations and of provisions for depreciation have no more relation in principle one to the other than the payment of any other liability has to

maintenance charges. Sinking funds created solely to provide means of restoring waste or wasting capital would of course present an entirely different accounting question from that presented by sinking funds created for the liquidation of debt obligations.

Municipal obligations in the shape of bonds are issued as a rule with sinking fund provisions under which it is expected that the obligations will be ultimately retired. These sinking fund payments are made or provided for by a specific item of assessment included in the general tax levy. In municipal statements the taxes assessed or the taxes collected, including the special item for sinking fund purposes, are generally treated as revenues or income, and as a contra account there is usually included in these statements a corresponding charge covering the sinking fund disbursements. The principles underlying payment of debt obligations through the medium of partial payments are not, however, in any way affected by the fact that the debt is owed by a municipality instead of by an individual or a corporation.

Accounts for Fraternal Beneficiary Societies*

BY F. M. SPEAKMAN, C, P. A.

In presenting a general outline of an accounting system for fraternal beneficiary societies I will assume the case of a society which employs agents for the upbuilding of its local lodges with life insurance as the principal business of the society. In a well organized society of this kind there would be main departments, as follows:

- Agency or field department.
- Policy or certificate department.
- Medical department.
- Accounting department.
- Claim department.
- Investment department.
- Actuarial department.

The first question that presents itself is the handling of the applications for membership received from the agents, which applications are first presented to the medical department for investigation as to the physical fitness of the applicant, a record of approvals and rejections being maintained by the medical department. In the case of a number of societies, however, these data are compiled by the actuarial department, likewise records pertaining to the causes of death and disability. The agents are employed on a basis of a fixed sum per application, salary, commission, and in some cases a combination of all three. The agency or field department maintains records showing the different contracts held by each agent and the compensation allowed.

For the purpose of keeping track of the business and earnings of each agent two books are suggested, preferably loose-leaf, the first book being what might be termed a blotter, in which a page is allotted to each agent with notation as to his contract provisos. The application, upon its receipt from the medical department, in event of the application being approved, is given a number, said number corresponding with the number of the policy or certificate that is issued. The rejected application should likewise be given a number and be entered on the blotter

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under the agent's account, in red ink, or by other method to readily distinguish it from the applications which have been approved. This blotter should be ruled to show information as follows:

- Date approved or rejected.
- Name.
- Location.
- Lodge number.
- Policy or certificate number.
- Date issued.
- Age.
- Amount.
- Premium rate.
- Columns for application fees charged and paid.
- A number of columns for entering commissions as they accrue.

This record will then give a complete list of the applications received from each agent with all the information in reference to each application that is necessary in handling the agent's account satisfactorily. Further, this record is totaled monthly and carried to the agent's ledger account, which should likewise be in loose-leaf form, and should contain information somewhat as follows:

- Date.
- Number of applications.
- Amount of insurance.
- Gross commission.
- Loss by lapses.
- Commissions earned.
- Charges against commission.
- Probable credit.
- Application fees—debt and credit columns.
- Several columns for cash paid and for miscellaneous items.
- For payments made by the applicant, there would be an entry made in the blotter and the date of its receipt.

We will assume that the contract of this particular agent provides for the payment of commission of 50 per cent of the first year's payments. The total commission that would be due under the contract would be computed and credited in the agent's ledger account under the head of "gross commissions." The agent's interest in the premiums paid would be credited in the agent's ledger in the column headed "commissions earned." The column headed "loss by lapses" would contain that portion of the agent's commission which had been previously credited in the gross commission column, with all hope of its actual accrual to the credit of the agent lost by reason of the lapse. Any pay-

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ments made to the agent would be charged under an appropriate heading, whether for salary, advance, commission or expenses, and any portion of those payments which were a charge against the accruing commission of the agent would be entered in the column headed "charges against commissions." The column "over-draft" would represent the excess of charges over actual commissions earned. The item "probable credit" or, as we might term it, "possible future earnings," would be the premiums from the applicant due in the future and in which the agent has an interest.

This method permits the management to see at any time the amount of business being produced by the agent, the proportion of rejected applications, the solidity of the business secured, the earning power of the agent under his contract; and to keep in accessible form the overdrafts made by the agent and the possible future credits to protect such overdrafts or excess payments above commissions actually accrued—in fact it gives instant information as to the desirability of keeping any particular agent on the pay-roll.

One feature of fraternal organizations is that the premiums are usually paid monthly, the collections being made by a duly authorized officer of the local lodge who keeps records showing the payments received from each member and who furnishes the home office with a report for each period, showing the collections made and remitting therewith the amount of such collections. This means that any system of members' accounts must first take into consideration a group of members comprising the local lodge. A system best adapted to this is that of cards containing the name of each member and all necessary facts in relation to the policy or certificate held by him. With the membership cards for each lodge there would be what is termed a base card, which would be headed by months and would be ruled to provide entries for about four years, a record of the receipts from the particular lodge being kept on such base card. The monthly report received from the officer of the local lodge may be in two forms—a form containing a complete list of the names of the members paying, with divisions for listing those who lapsed, died, transferred to other lodges, or were reinstated during the particular period.

Another form of report is known as a base report. This

report would commence with the total premiums due from that lodge the previous period and show as additions or deductions the changes in membership that occurred during the month or period. With the use of a card system in the home office the report requiring a complete list of names of the individual members each month is preferable for reasons that will doubtless appear obvious. In a card system of this kind the individual card of the member is not marked in any way, except when a change occurs. At the end of the month the card files would contain a record of the policies that were in force, or those that had lapsed, died, etc. having been removed from the file when verifying the reports of the local lodge and proper notation placed on each card; so that any given policy or certificate is known to be in force by reason of its being in what might be termed the "live file" and the absence of notations thereon as to lapses, etc.

There has been so much said and so many ably written articles upon the advisability of a card system for the keeping of the membership records that it is hardly worth while to go further into this phase of the system. In practically all of the leading societies the card system, in so far as the membership or lodge records are concerned, is used. The cards constituting the lodge record do not, however, enable one to readily obtain therefrom the statistical information required, even though they do simplify the work of the accounting department; this for the reason that it is not convenient or desirable to even temporarily destroy the arrangement of these cards.

In speaking of statistical information I might state that these data would be handled perhaps in their entirety by the actuarial department. To secure the information in a well regulated office, and this applies to all societies, whether their membership be numbered in the hundreds or thousands, a system of cards independent and apart from the regular card system or book-record used for local lodges should be maintained. These cards should contain all the information in regard to a particular certificate, the essential information being somewhat as follows:

Number of certificate.
Amount.
Kind.
Date of birth.
Date of admission.
Age at date of admission.

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Rate or amount of payment, whether monthly, quarterly, semi-annually or annually.

Space for the recording of terminations either by death or lapse.

Any other information that may be desirable for statistical purposes.

These cards are written at the time the policy or certificate is issued, or when the membership card is made out, or when the member's name is placed upon the lodge record. These cards, as they are written, are retained by the policy or certificate department until the end of the month or any other convenient closing period and are then sorted and a record made of the number of issues, amount, etc., grouped as to states. These figures are then added to the record at the close of the preceding month and the cards filed numerically in a permanent file, the permanent file being divided as to kinds or forms of policies issued. During the month the reports containing information as to lapses, revivals, etc., as received from the local lodges, are verified. Those reports which show a fluctuation in membership are taken and the cards corresponding to those fluctuations are removed from the permanent file to a separate division, the results being tabulated at each closing period, as in the case of new issues.

This so far will give a complete current membership record showing the amount of insurance in force, the number of policies, the number of issues, amount of issues, number of deaths, amount of claims, number of lapses and the amount thereof, all classified as to states. The permanent file of policies in force is arranged as to kinds of policies and the divisions are arranged numerically in accordance with the policy numbers. The cards will likewise be in chronological order, guide cards being inserted for the business of each year, the lapses and deaths being arranged in practically the same manner. In the larger offices subsidiary records should be kept showing a classification of certificates by kind of certificate and also by year and age at entry; for example:

We have determined from our record the number of certificates and the amount of insurance issued during a particular year for each kind of certificate. A sheet is made up and this particular form of certificate indexed according to year and age at date of issue. We will suppose that during a given year there were issued 1,000 certificates at age 27, with protection or insurance represented by these certificates aggregating \$1,000,000.

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We have then as a base for the future the above data, from which the terminations would be deducted as they occur, the remainder representing the number of certificates and amount of insurance still in force that were issued during that particular year on applicants who were at that time aged 27. In the smaller offices such a record would not be necessary as the age distribution can with much less work be secured by sorting the cards by ages at the time the age data were required. We now have a record from which can be readily secured any information that may be necessary for the purpose of making a valuation, or for computing the death rate of the society and comparing the same with any table of mortality which may be selected.

The principal feature, in fact the very purpose of a fraternal beneficiary society or insurance company, is the payment of claims. The funds with which to make any and all payments are, of course, collected from the membership and such other sums as may be added by reason of investments, etc. The business of insurance is, therefore, what might be termed a cash business, and the general books need not consist of more than a cash book and ledger with suitable subsidiary records for the recording of receipts and disbursements. It is essential that columnar books be used which will show all sources of receipts and a general classification of disbursements, the classification for both receipts and disbursements following closely the general classification required by various state departments. Each column in both the receipt and disbursement books should be given a number, which number will denote a ledger account for all items appearing in that particular column. To illustrate this more fully:

We have in the disbursement book a column for investments, and let us number this column "20." A column will likewise appear in the receipt book, headed "Investments Repaid," which column will likewise be numbered 20. Investments as appearing in the general ledger may consist of perhaps 15 accounts; in other words a classification of investments. Each account in the ledger pertaining to investments will likewise be numbered 20, meaning that all items appearing in ledger account bearing the number 20 are posted from columns 20 appearing in either the receipt or disbursement books. The advantage of this is in localizing possible errors, and it enables one to verify each ledger

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account by comparison with the totals appearing in the receipt and disbursements records.

We recognize the fact that at least 95 per cent of the items entered in the receipt book represent payments received from the local lodges; therefore it is better to have what might be termed a "subsidiary receipt book" showing in one column the receipts from lodges, which book is totaled daily and the sum daily transferred to the general receipt book. This subsidiary book would be practically the same as a record used by the receiving teller of a bank for recording individual deposits, the sub-divisions of premium receipts for the several funds of the organization being made at the end of the month or at the regular closing period.

In connection with the subsidiary receipt book it is desirable to have another record arranged by lodges with columns for each month or settlement period throughout the year. In practically all organizations of this kind each lodge is given a number. The number of each lodge would be listed consecutively in this record and the receipts from each lodge would be posted in this record in the column headed for the month during which received. The entries for each month or period would be totaled, which total should agree with the total receipts from lodges as appearing in the general cash book or ledger account. At the end of the year the receipts from each lodge would be ascertained by a cross addition and the amount of receipts from each state determined directly upon the close of the record for the year. Another purpose of this record is for that of audit and a verification of premium income.

The manner of making payments varies in each organization, but as the payments are made either on account of claims or expenses there is no reason why the same system should not be applicable to all organizations, barring any peculiarities in the by-laws. We find that in the majority of organizations two or more officers sign all checks, the cumbersome order system in vogue in a great number of societies not being necessary. In fact the order system is a useless waste of time and energy which could well be applied in some other direction.

For making all payments, whether for benefits or expenses, the voucher system in a modified form is rapidly supplanting the former methods as it obviates the necessity of securing a receipt from the party to whom the check is given. Furthermore, you

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are sure of getting a receipt in the form of the cancelled voucher after the payee receives the money. Any number of voucher forms could be printed to conform to the different payments to be made, for example: You are paying a death claim. The voucher would contain a release of the policy or certificate on which the claim was based. These check vouchers as they are returned from the bank give you a receipt stating the purpose of the payment; further, all the vouchers are numbered consecutively, and being of uniform size can readily be filed. All vouchers or checks are entered in the disbursement record in numerical order, a column being provided for the numbers thereof. Where items are numerous and a separate claim department maintained it is well to have a subsidiary disbursing book entering therein all payments for claims, columns being provided for a classification of the kind of claims. The totals of this subsidiary disbursement record are carried to the general disbursement record.

The records in the claim department will of course depend largely upon the nature of the claims and the method of payment, whether the amount of the claim be payable in one sum or over a period of years.

The society receives notice of a claim, said notice being either on a printed form provided by the society or any other form that is desired by the person sending in the notice. Data in regard to the particular policy under which the claim is made are secured and the claim given a number, a record thereof being maintained in a book especially ruled for the purpose and having columns as follows:

- Claim number.
- Policy-holder.
- Policy number.
- Lodge number.
- State.
- Date notice received.
- Date proofs received.
- Face amount of policy.
- Date paid.
- How paid.
- Amount of scaling if any.
- Amount paid.
- Remarks column.

Twelve distribution columns—one for each month—the amount paid being inserted in the column corresponding to the

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month in which payment is made. In case the policy was payable in monthly installments there would of course appear a payment during each month throughout the year and the balance of the claim remaining unpaid at the end of any particular time being extended in a balance column. From this record the number of claims, the amount incurred, the number and amount paid, saved by scaling, and the number and amount of claims unpaid, are ascertained simply by addition of the various columns. You have also an itemized record of the monthly payments made on account of claims, the totals of which agree with the book of claim disbursements, the general cash book and the general ledger accounts.

A summary of claims incurred and paid by states can readily be secured at any time by simply listing the various items for each state, although in a larger organization, where a great number of claims are handled, a card record of claims incurred and paid is advantageous as these cards can be sorted and any statistical information desired obtained therefrom.

The principal items of investment for fraternal societies are, of course, mortgages on real estate and various forms of bonds, although there may be other investments as stocks, real estate, bills receivable, etc. In the general receipt and disbursement books, previously described, there were columns provided for investments, the column headed "investments" in the disbursement book containing all disbursements made for an investment purpose and the individual items charged to the appropriate investment account in the general ledger. In the column appearing in the receipt book headed "investments repaid" are entered all items of investment retired or reduced in amount and the individual items credited to the appropriate investment account in the general ledger, leaving the general ledger accounts for investments to serve as control accounts for the subsidiary investment ledgers.

The investment ledger or ledgers should contain an individual record of each mortgage loan or class of security. In the case of the mortgage full date would be given relative thereto, with appropriate debit and credit columns for interest and payments on principal, tax receipts submitted for inspection and the amount and expiration dates of fire insurance held. A trial balance of the subsidiary ledger as to mortgages, for example,

would agree with the control account for this particular class of investments, as shown in the general ledger. Appropriate accounts for other forms of investments are maintained in the same subsidiary ledger or ledgers, the total of the items therein agreeing with the balances shown by the respective control accounts.

In respect of bonds where the amortized method is used the amortization accounts may be maintained for each class of bonds in the subsidiary ledger and the book value of the bonds, as shown in the general ledger, changed from time to time, as determined from the amortization account. For the collection of interest, etc., a card record is maintained, arranged by interest dates. As the interest payment is received the card is moved ahead to the next interest date, new cards being added for new investments, and the cards removed for those investments which are retired.

In connection with investment, there is one other item to which very little attention is given, except when comparing the annual statement, and that is the item of accrued interest. At the cost of little time a current record of accrued interest may be maintained by having a summary sheet of investments at the various rates of interest. Ascertain and make a record of the interest due and accrued on a given date and either daily or monthly ascertain the amount of interest accruing on the several investments and add same to the former amount. From the sum thereof deduct the interest received and the balance will represent the interest due and accrued at the end of the day or month, as the case may be.

We recognize that our organizations operate under by-laws which present certain problems in accounting that must be worked out separately for each organization. Each has peculiarities of its own. Therefore in so far as detail is concerned it would be impossible to outline a system exactly suited to all. There are, however, essential features which are common to all, and it seems to me that the system outlined describes briefly but in concise form a simplified system of accounts which with little modification would meet the present-day requirements of nearly every society. Certainly it might be used as the basis of a uniform system among our societies in case the subject is regarded of sufficient importance to work in that direction.

The Ethics of Accountancy

BY J. PORTER JOPLIN, C.P.A.

In discussing the subject of the ethics of accountancy it will be necessary to recognize at the outset that accountancy has taken its place among the professions; consequently whenever considered and in whatever manner it must be remembered that it is to be dealt with as a profession. It must be understood that there is necessarily a wide difference between the attitude assumed by the professional man and that of the commercial representative. Undoubtedly what might be considered perfectly legitimate from a commercial point of view would not stand the scrutiny of investigation when viewed in a professional light. Therefore we must assume that if we are dealing with the "ethics of accountancy" we are also dealing with "professional ethics." This subject is perhaps as vital to the accountant as any other subject that might be considered. It determines his attitude and procedure when practising this profession; and it is, as it were, the heart and soul of his activities.

The *Standard Dictionary* gives the following definitions:

ETHICS: The science of right and of right character and conduct. The principles underlying the obligations of moral beings. The science of human duty. Any body of principles or rules concerning moral obligation that is intended to regulate practice in any particular sphere of activity.

PROFESSION: An occupation that properly involves a liberal education or its equivalent and mental rather than manual labor.

Any calling or occupation involving special mental and other attainments or special discipline.

Undoubtedly all are familiar with the "Decalogue" as presented in the *Old Testament*, and the "Sermon on the Mount" as presented in the *New*. These two would seem to be a fair and grand exposition of what we might term "Ethics."

It has been well stated by a prominent writer on this subject that there should be a minimum standard below which, by common consent, we should not go; that abstract right or wrong, it must be well understood, is immutable; and that surely we will make the acknowledgment that stealing is absolutely wrong. It is also claimed that we should aspire to advanced positions and these positions should be adopted as readily as our perception

of moral principles may develop. It might be well to state here that whatever we may aspire to we also may strive for, and in so far as possible develop it and put it into practice.

Perhaps one of the most important things for an accountant to consider, when viewing the subject under discussion, is the matter of his relation to his fellow practitioners, and it may be well to dwell a little upon this subject. There are many points that present themselves.

It is well for us to keep in mind that under no consideration whatever is there anything to be gained by underrating or underestimating those who are practising the same profession or presenting themselves to the public for consideration in the same manner as we ourselves. There may be instances where our fellow practitioners may seem to us to have less regard than we might wish for the ethics of the profession as we understand them. Still, it would be wise for us to refrain from criticism and to endeavor to follow our own course according to our light, living up to our highest ideals, whatever these may be. On the other hand, consideration of a breach of ethics of a flagrant nature, that would seem to necessitate our taking notice so that the public may not be imposed upon, must sometimes be faced; and in such instance we must be prepared to act for the right, even if it necessitates the taking of action against a fellow accountant.

As an illustration of what I have said I might cite a case in point which occurred in one of our states and which may be of interest. I will briefly outline the circumstances.

A certified public accountant who had received his degree from the state university prepared, published and circulated a pamphlet which belittled the profession he was supposed to honor, and after much thought and consideration action was taken by some of the certified public accountants of his state, which ultimated in bringing the matter before the authorities of the university, and a trial board was created for the purpose of hearing the case. A brief was carefully prepared, and testimony was given by several accountants as to what they considered professional, and a hearing was arranged for the one who was under charges. However, he made no appearance, either in person or by counsel, but offered to resign or to turn in his diploma. This did not seem to be, in the judgment of the trial

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board, exactly what was desired, so the case was continued and the party on trial was judged guilty and his diploma was forfeited. This instance is cited so that it may be seen that circumstances will sometimes arise to compel taking action against fellow practitioners.

Perhaps one of the most desired achievements to attain is that of having a reputation among our fellow accountants for probity, honor and justice. It is a source of gratification to know that we are held in high esteem by those who are working toward the same end as ourselves, and are coming in contact with the same public with whom we also must deal. Should any accountant wish to know the facts about the character, aims and practices of any other particular accountant he cannot satisfy his desire in any better manner than by learning from such fellow practitioners as may have had the advantage of working for a period of years in the same community as the one who may be under discussion.

There are times when we have to face what is termed competition, and in this particular, as previously stated, it is well to remember that there is a wide difference between commercial and professional pursuits, and it is claimed by some writers that there should be no professional competition. This, however, is a question that may be considered, from the fact that, while we may not compete directly with each other for clients or for clients' business, we are in a broad sense competitors. It has unfortunately been the practice of some professional accountants to adopt a plan of soliciting for business, at the same time claiming that there should be no objection to such procedure. It will probably be conceded, however, that no reputable professional man would care to solicit business on his own account from strangers, and if his attitude should be such as to prevent his doing this for himself it would seem reasonable to suppose that he would consider it quite as bad to employ some one to do it for him; and to place men in the field to solicit business on a commission would be entirely unprofessional.

In the matter of superseding another accountant it is undoubtedly desirable that a reason be known why the change is desired. There may be circumstances where the client has differed with the accountant and desires to be rid of his services

because he has not been amenable to certain conditions to which his professional instincts would not permit him to accede. In such a case it would be well for the accountant who is expected to assume the duties to be well posted before making an engagement. To seem in any way to desire to take away the business of a fellow accountant would be reprehensible and should be utterly condemned. If there is a good reason why the client desires to change, and the reason is satisfactory to the accountant who is requested to assume the duties, it would seem to be permissible for him to accept the assignment; he should, however, feel reasonably sure in his own mind that in similar circumstances he would not object to being superseded.

In considering the relation of the practising accountant to his clients it will be well to remember that all information obtained from a client, or through any connection with the work on which one is employed, is of a strictly confidential nature. Under no circumstances may one divulge information received from a client when engaged by him. Our clients must feel absolutely assured that they may confide in us with the utmost safety. Confidence once established, the accountant will be placed on a footing which will make it possible for him to be of the greatest service and will enable him to work advantageously for the best interests of the client. Services performed faithfully in small matters will prepare him for the undertaking of matters of greater magnitude that will necessarily follow, and will also fit him to perform these matters of greater magnitude in such a manner as to call for commendation and approval. It will be borne in mind that work well performed invariably brings its reward.

It may be necessary at times for the practitioner to show to the full forcefulness of character, to the end that he may stand for what is right even when the client is of different opinion, and even to the extent that he may seem to stand alone. Should he be assured that he is in the right he cannot recede from a position taken, and he must exercise his courage of conviction and stand firm. Such situations come to all of us in our practice, and at no time can an accountant afford for one minute to recognize in any way that may be brought to bear on his attitude the fear of losing either the client or the fee that is involved.

The necessity of good humor and the desirability of court-

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eous manners would seem to be quite obvious. No accountant or auditor when presenting himself at the office of a client, in the course of his work and duties, should make himself so obnoxious that those employed in the office find reason for complaint of his attitude. Surely it is possible for him to approach any work that may come to him with a view to accomplishing what is before him without antagonizing those with whom he may come in contact, who, perhaps, may not be as well informed on methods and procedure as he is and who have not had the same opportunities. They are rather to be assisted and helped into better conditions than to be censured and condemned. It is also undoubtedly true that it is always possible to secure better results and more easily obtain desired information from those with whom one comes in contact, by treating them courteously, than by assuming a position of superiority which is neither wise nor advisable in any circumstances or conditions.

Aside from the responsibilities of the accountant to his client, there is his relation to the general public to be considered, and it should be remembered here that his duty to the public is perhaps even greater, if it were possible, than to the client, when certifying to the accounts of a company under examination. The public is not so well versed as he may be in the wording of a report, and the mere fact of his having given a certificate on the revenue account and balance sheet may be considered as justifying the representations of the company under review. It is therefore most desirable, in fact it may be said to be imperative, that the wording of his certificate should be such that there may be nothing misleading, and that his statements should be exceedingly plain and clear. Qualifications, if they must be made, should be so stated that there can be no misinterpretation. It may be well to say here that qualifications should be used as little as possible. It is possible at times that the directors of incorporated companies may be desirous of showing the revenue of their company to be not quite so good as the actual facts would indicate, the purpose being to cause the shares of the company to be slightly reduced in price, so as to enable them to purchase to advantage; or it is possible that the profits may be so over estimated as to give those with inside information advantage over the general public. Such cases may sometimes present themselves, and that is the time when the accountant or auditor must stand firm for the

principle to which he is obligated, and it is necessary that he should word his certificate in language so plain that there can be no mistaking the wording or the intent which it is desired to convey. A secret reserve may be a good thing for a company to have, but the intention in creating such reserve may not always be of the best.

The question of contingent fees would present itself here. It has been put forth and held by some accountants of high standing that there are circumstances in which contingent fees are permissible. This, however, is a grave question and one that the practitioner will have to settle for himself. It may be stated that, as a rule, contingent fees are frowned upon by most professional bodies. An accountant may be engaged to perform an investigation which may later develop into an engagement to testify as to his findings in a court of law. One of the first questions that may be asked of him is as to whether his fee is contingent on the findings in the case, and if such be the fact his evidence will be discredited by any intelligent jury. I do not wish to state that in no circumstances whatever should an accountant arrange for a contingent fee, but I do wish to say that the circumstances when he may do so are limited, and great wisdom must govern him in deciding the question.

Not infrequently there is presented to the profession the question of a uniform scale of prices. For many reasons this would seem to be objectionable. The professional accountant will not always make his charges commensurate to the work performed, inasmuch as there may be times when the value of the services cannot be estimated and will reach far beyond the expectation of the client, but there must necessarily be a sliding scale which would permit of increased fees in certain directions, which a uniform scale of prices, lived up to, might prevent. There may, however, be a minimum established in his own mind below which he should hesitate to go unless it were to meet the necessities of a client not able to make the remuneration adequate to the services rendered.

Undoubtedly one of the most difficult phases of the practice that the accountant comes into contact with is that of underbidding. This phase of the situation is usually brought about through men either unqualified to practise or so desirous of obtaining work that they lose sight of the harm they are doing

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and of that which undoubtedly will come home to them in the future. Ordinarily the client will know whether he is paying too much or too little, and there are many cases where work has been obtained through underbidding, that, no matter what the fee involved may have amounted to, proved in the end to be a poor investment for the client. Again, not infrequently we come in contact with the shopping client, and the accountant will do well if he declines to state any fee when it is known that inquiry is made so as to draw comparison with figures obtained from other accountants. In the long run this procedure will be found to be the right one, and the portion of the public who adopt the shopping plan will learn that the better way for them to proceed is to select their accountant, determine as to whether he is all that they think him to be, and place their affairs in his hands subject to his general fees. The wisdom of this course may seem at first somewhat problematical, but the practitioner will find that by pursuing it the public will become gradually educated and he will be held in higher esteem than would be the case should he fall in line with any plan that would make for the appearance of bidding on prospective work.

The writer has before him half a dozen circular letters addressed to one of his firm's clients by practising accountants setting forth the desirability of employing them in connection with meeting the requirements of the federal income tax law. The great objection to such a manner of informing the business world that the accountant is the one to call upon in this and similar connections is the fact that it has the effect of accelerating the desire of the client to shop, for when six different accountants solicit his patronage at about the same time there is a tendency to weaken his respect for the profession and create in him a desire to find out which one will answer his purposes at the lowest cost to him. It has been offered as an excuse that the general public is not well informed on the duties and practices of the accountant, and that circular letters give new impetus to the activities of the profession. This argument may have had a semblance of truth at a time previous to the forming of our state societies, but it would seem that today it is not a valid reason. The general public has become fairly well informed as to the advantages of employing the practising accountant and auditor, and it is well not to deceive ourselves as to the purpose of such letters. In

fact the circular letter is a direct attack on the business of a professional brother, for undoubtedly when these letters are sent broadcast, as they usually are, they reach, to a large extent, firms and corporations which are already employing practising accountants; and in fact the very practitioner whose clients the signer of such circular letters would not wish to disturb is the one whose attention is drawn to this breach of ethics.

A plan which suggests itself at this time might be carried out to advantage through the medium of state societies. If the state society would carefully prepare a letter showing very clearly that the accountant is the man to be called upon in connection with determining the figures when stating the amount of the income tax, and annex the names and addresses of all the practising accountants in the society, firm names if desired, and mail a copy to each member of the chambers of commerce, manufacturing associations and institutions of a similar character in the state, it would have a more desirable effect than that attained when each individual member circularizes the same people.

In the practice of his profession the accountant will of necessity require assistance, and we may well consider this subject as a most important one. Much of the work performed is done by the assistant, and he enjoys to a large extent the confidence of client as well as that of his principal. His training should be such as to fit him eminently for such confidences, and on the attitude of the accountant and the supervision and care that he gives to such training will depend largely the ultimate success of his assistants. It is a duty that the accountant owes to himself that his assistant should have every opportunity for the complete development of his abilities, at all times being treated with consideration and assisted with helpful advice. Undoubtedly many perplexing circumstances will present themselves to the assistant's notice when he is perhaps not in position to refer them to his principal, and it is but natural that, when these matters are reported to his principal a thoughtful consideration and careful analysis of the difficulty that besets him, with kindly words of advice, will be fully appreciated; whereas, a different attitude would have the effect of discouraging him and perhaps cause a weakening of his self-reliance. The success of the practising accountant will be largely wrapped up in the manner in which the work is performed by his assistants, and while he may be suc-

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cessful in keeping a thorough supervision of all the work performed, there are many times when he must largely trust to the work of his staff. It therefore behooves him to see that his assistants are well versed in all matters pertaining to the profession, not only regarding its technique and practice, but also its ethics.

Accepting the premise as laid down at the outset of this article that accountancy is a profession, it is necessary for us to thoroughly understand that the services to be rendered are of a personal nature and in consequence thereof there must be a personal responsibility. While it is quite natural that partnerships should be formed so as to facilitate the manner of conducting the affairs of an office, this does not in any manner lessen the individual responsibility. It would seem, however, that in incorporated companies, created for the purpose of practising accountancy, the individuality would be lost, and the responsibility attached to that individuality would in a manner also be lost. There are some forms of incorporation where all the stockholders, directors and officers are accountants, and this form of corporate accounting is not so much to be deplored as that of incorporated companies which are formed purely for commercial purposes, where the directors and advisory boards cannot in any way or form be considered practising accountants. The value of an accountant's signature or certificate will always be based on his personal integrity and reputation, and cannot in any way be enhanced by the amount of capital stock which is supposed to be back of the signature of the officers of an incorporated company.

There are many other features which might be touched upon at this time, and which are well worthy of discussion, but perhaps it will be as well to sum up as a general proposition those things which have been previously referred to, as well as others that have not been specifically treated. It is somewhat to be regretted that the age has reached the point where, among a large class of our people it is deemed that the measure of success is the dollar; but the writer is constrained to say that, in his opinion, this will have to change, and the true measure of achievement will be placed on a somewhat different and higher basis. If the accountant achieves for himself a position in which he has the respect, the confidence and the goodwill of the community in which he lives he will have more to be proud of, and

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will have reached a higher measure of success, than would be possible by any achievement of what may be called material wealth. It is well to remember that it is within that we must look for high ideals and for the source of all right and true action, and the closing lines of the speech which Shakespeare puts into the mouth of Polonius when speeding his son on his way to France, will sum up the matter.

* * * to thine own self be true,
And it must follow, as the night the day,
Thou canst not then be false to any man.

In this profession as in all other professions it is by having ideals and working for them, always keeping in mind that true success means the achievement of results approximating as nearly as possible to those ideals that one has pictured for oneself, that one can, as it were, become satisfied with one's work. It is the men who work for ideals who are the support of a nation, and it is ideals of a high character that make for the stability of a nation. Emerson said "Hitch your wagon to a star." It would be well for the accountant to have ideals of the highest, for it is in accordance with the way in which he lives and conducts himself in this profession which he has adopted that he will bring both respect upon himself and credit upon the calling which he follows.

Responsibility of the Accountant

BY EDWARD L. SUFFERN

The duties of the accountant engaged in the examination of the financial condition of any enterprise and reporting thereon will vary somewhat in accordance with the special purpose for which such report is designed.

The most frequent occasions for the use of accountants' services are in connection with the obtaining of bank credits through certification of applications for loans, and it is gratifying to the accountants, at least that such certifications are being demanded more and more. Because of this fact, bankers are very properly holding accountants to a rigid responsibility which imposes upon them the obligation to be assured that every statement contained in the application is correct.

The general attitude of accountants is entirely responsive to this obligation. Every conscientious accountant is most desirous of having his report of every nature set forth every fact in the most exact and enlightening manner. He wishes to present clearly every essential feature and to be absolutely certain that each one of them is right. That is his ideal and to attain it he is striving earnestly in every case.

The trouble is that he cannot in a great number of cases be assured of his own knowledge that every item is right and to make plain some of the difficulties in the way is one of the purposes of this article.

Every statement of condition should include at least the following elements:

On the asset side:

- Cash
- Accounts and notes due from customers
- Merchandise on hand in various forms and however subdivided
- Tools of trade of all descriptions
- Equipment of all kinds and in many cases forms of fixed property, such as buildings, real estate, etc.

On the liability side would appear:

- Loans due banks or individuals
- Accounts due trade creditors and others
- Accrued indebtedness items, if any
- Mortgage indebtedness where such existed;
- Also the capital investments.

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The accountant's duty is to ascertain the correctness of the amounts representing the above items, and as many others as may be necessary and report his judgment thereon. Until one should try to do so, it would seem as if that were an easy performance, and so it would be if all that should be needed were extracting the figures from the books. It is right there, however, that the trouble begins.

To prove the cash is easy and takes little time. The second item, accounts due from customers, is also simple, although it may take a good deal of time to check the balances where there are large numbers of accounts. Each one must be examined to see whether it is old or new and be classified accordingly, also its relative size as compared to previous balances should be observed. Notes receivable must be proved and this is usually quite easy, but it is when we come to the next item "merchandise" that the real difficulty is encountered.

It seems to be commonly expected that the accountant should be able to prove this class of assets as accurately as he does the cash, and so he can, approximately, where a complete, scientific system of accounts is kept—accounts which show the amount of everything on hand currently—accounts which show the cost of all goods produced at any stage of production and which present clear and intelligible figures upon which calculations can be made. Where such accounts exist, it is possible to be reasonably accurate as to all forms of merchandise counted as assets.

Unfortunately, however, such accounts are quite exceptional. Ordinarily, it is exceedingly difficult to ascertain close values otherwise than by taking an actual inventory, and this is almost always a tedious and expensive undertaking. It is rarely the case that the accountant is associated with the force engaged in taking the inventory even when the date at which it is taken coincides with that upon which an audit terminates. This places upon the accountant the necessity of checking the inventory by the best means available after it has been completed and frequently at a much later date, a process which in most instances precludes him from forming more than a general opinion as to its accuracy and forces him to rely upon the assurances of others that it has been taken carefully as to count and truly as to values. In such circumstances the accountant is justified in making his

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certificate qualified as to such matters which he cannot positively verify.

Where an examination is made independently of an audit and at a different period, it is clear that the accountant can do little more than to make and accept estimates as to the correctness of the values placed upon merchandise (except in the cases described above where proper accounts have been kept).

The objection is frequently made that a qualified certificate does not serve the full purpose for which a certificate is desired. That is true. Every unconditional assurance is more valuable than a qualified statement, but honesty and conscience demand that no man shall state anything as being fact unless he know that it is such. This is especially important where the accountant is, as frequently happens, called in to make an examination of condition and is expected to report very quickly. In such cases he should state in positive terms only such things as he knows to be true and qualifiedly those which he cannot know absolutely. This quick work should be discountenanced as much as possible.

On the liability side the danger point seems to lie in the accounts due creditors, as well as in the notes payable. Where the accounts are properly and honestly kept these items are as easily handled as any others, but where for any purpose, either intentionally or otherwise, wrong records are kept the accountant is at a great disadvantage in his examination.

The notorious failures of a few years ago, where it was discovered that immense sums of discounted notes were not entered on the regular books as part of the obligations, have caused accountants to be more wary than formerly and to try to prove the amount of outstanding notes payable through every possible channel; consequently it is more difficult to conceal obligations of this kind than it once was. When we come to open accounts due creditors, however, we find it is much more difficult to be sure that all obligations are recorded than in the case of notes. If a note has been issued some one has it and it is usually possible to trace it; but invoices for goods purchased, or any other like debts, might be destroyed or filed away without being entered, and the accountant could not of his own knowledge be aware of the fact, especially if he had had no previous or regular relations to the concern under examination.

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To the mind of the writer the safest method for the accountant to adopt is to secure from a responsible person, partner or officer a signed statement that the obligations of the concern are all recorded on the books or submitted for investigation. A somewhat similar statement should be made in respect to the values at which the merchandise appears on the exhibit of assets, and where an inventory has been taken it should be signed as correct by some highly responsible person. In this way the accountant can protect himself as to matters which are beyond his own ability to determine and can qualify his certificate correspondingly.

In a considerable majority of cases the accountant can be reasonably sure of the correctness of nearly all items of the accounts, particularly where he has familiarity with the concern and has learned its methods; but where he has any doubts at all he should use every precaution to satisfy his doubts and if any still exist to distinguish between things he knows and things he may question.

The larger purpose for which an accountant's services may be desired by bankers is where new capital may be required and the report would become one of the very important factors which would determine the investment. The examination which would be undertaken for such a purpose should cover much more ground than that which is described above. The latter has to do with the ability of a concern to pay its obligations; the other must consider not only this question, but the larger one of earnings.

It is in such an investigation that it seems to the writer the accountant may find one of his most valuable opportunities of service. It is usually a simple enough matter to examine the profit and loss account of a concern and to make up therefrom an exhibit of yearly earnings which shall set forth fairly well all the essential elements for an intelligent understanding of how the profits or losses have been created "according to the books." There is very much beyond this, however, which the accountant should do. He should carefully study these elements one by one and the relation of each one to every other, so as to see just what its effect has been upon the total outcome.

For instance, the volume of business transacted, taking it as

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a whole, may have been insufficient to produce a proper profit on the year's operations owing to the heavy general overhead, and then it would seem reasonable to suppose that if the volume could be increased without correspondingly increasing the overhead a satisfactory result would be reached. That would not be so necessarily. An analysis of this volume might show (and has in some instances) that the total costs of the regular and staple classes of goods sold so nearly approached the selling price that a fair margin of profit would be unrealizable no matter how large the sales might become, and that the profits accrued during the year were due to some special business which was not likely to recur.

What the banker would want is information which would enable him to judge of the probabilities of the business, as well as a knowledge of its past, and such information is only obtainable through a careful study of the meaning of every factor which has contributed to its history. This is really "research work" and makes large demands upon both the general and the special knowledge of the accountant. It is necessary work, nevertheless, and of high value.

Among the things a banker wants to know is the probability that the new capital investment will accomplish the full results for which it is required. Will it be adequate for the needs, or not, and if invested will it have a profit producing energy or be dormant? To such questions it is often hard to give an answer, but a reasonable approach to one can be evolved through the right study of the past results of the business, plus the economic conditions affecting it.

The difficulties which confront the accountant in the preparation of a financial statement for borrowing purposes are to be found still in the larger work, but can be more easily overcome, inasmuch as a report of earnings would cover a longer period, the examination of which would reveal errors of methods which would not be so readily apparent in the shorter term.

Any accounting service of any kind is assisted and improved if the accountant can keep before him the point of view of the one for whom the service is rendered. If one can clearly see just what information should be imparted in order that the report should be intelligible on all vital points to whomsoever

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might read it, the result will be a gain in clearness and definiteness.

The year recently closed was conspicuous in its effects upon accountancy. As this is written four large corporations are being violently assailed by groups of minority stockholders, on the grounds of mismanagement and the concealment of important facts through false reports. Whether the charges be true or not, it is evident that the day has arrived when stockholders, however much in the minority, are going to demand that the administration of corporate affairs shall be subjected to a more rigid and detailed scrutiny than has been customary in the past. This is quite as it should be. It will not only mean the higher service of the accountant and his increased recognition, but more important still the greater security of the investor and a closer responsibility placed upon the management.

Advertising an Asset on the Balance Sheet*

By EDGAR C. SALVESEN, C. P. A.

I have before me an editorial which appeared in the December 25 issue of "Printers' Ink." It was sent to me, as secretary of the Minnesota society, with a request for an opinion thereon. I thought it would be a good idea to prepare a few notes on the subject for this meeting and then throw the matter open to discussion. This article entitled "Advertising on the Balance Sheet," is in part as follows:

The recent holding in London of the twenty-first annual meeting of Pears, Ltd., and the statement made there by the managing director that 10% dividends had been paid for twenty consecutive years, were made by *Printers' Ink* the occasion for writing Mr. Barratt and making a pertinent inquiry of one who is known through Great Britain as the "Grand Old Man of Advertising." Mr. Barratt in reply says: "Replying to your question as to whether I am of opinion that all advertising should be charged to 'current expenses' of the year, I may say that although it is the custom here for professional auditors to require this to be done, I personally distinctly consider such method to be entirely *wrong*, and certainly it is contrary to my own experience and practice, too, when this business was a private partnership."

Although, according to present English accounting practice, Mr. Barratt is unable to follow out his inclination to figure a certain definite part of the advertising expenditure as so much good-will investment, it nevertheless would have been exceedingly interesting to know what percentage he would have figured, and on what basis. The fact that most accountants, bankers and others do not recognize advertising as contributing to goodwill or "investment" account is one thing; and the fact that practically all advertising men as well as many other auditors and bankers know that it does so contribute in a countless number of cases is another thing. That it is not the universal practice of auditors to put a value on goodwill derived from advertising proves nothing more than that the men of finance and figures have not seen how they are uniformly to do so.

Dicksee, the standard English authority on accounting, has written a book on "Good Will and Its Treatment in Accounts." He takes the view that the only excuse for inserting the item of "goodwill" in accounts is that such an amount has actually been paid by the present proprietor for the goodwill of a business. That is to say, in order to make a showing on your books of the investment or residual value of advertising, you have got to sell your business! Yet he admits that when a certain definite expenditure has been incurred by the proprietors of a business for the sake of *creating* a goodwill (as, for example, money spent on advertising a brand new invention) such sums can be debited to "Establishment Account" and "*in so far as these expenditures have been judicious a residual value will doubtless remain in respect of them which may fairly be taken as goodwill.*" Mr. Dicksee apparently feels that this may be taken as a license for wild-catting, inasmuch as he then goes on to say

* Paper read before the Minnesota Society of Public Accountants.

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"advertising of an ordinary description must only be capitalized (even temporarily) after the exercise of the greatest caution."

A manufacturer who sells out his business to a trust and walks out of the concluding conference, buttoning up in his pocket a check running pleasantly into seven figures, knows what part advertising has played in earning him that check; advertising has been one of the largest elements in his success. The men who buy realize it. The directors, in their discussions and votes, recognize the value of the advertising. Everybody in the house that knows anything about advertising knows that from half to three-quarters and sometimes even more of the appropriation fails to produce immediate sales but paves the way for future business. Only when it comes to the point of setting it down in the balance sheet is there any bogging. The advertising rarely gets a mention; it is not recognized as contributing to the good-will value of brands, trade-marks, trade-names, trade-characters, etc., but these are too often lumped confusingly with patents, licenses, grants, franchises and other entirely different elements.

Has this practice a right to be called conservative accounting? It is silence on a vital point. It is not a true description of the business. It is even a misrepresentation of the source of values.

It ought to be possible and ultimately practicable to ascertain the relation between the expenditures for advertising, for sales organization and for improvement of product and the market results of each and all of these.

Accountants will hardly move in this matter themselves. They are not hostile, but they are not definitely sympathetic. There has been no consistent pressure on them to analyze further than they have done in the matter. But that it will be done sooner or later there is no room for doubt. Advertising as it grows into fuller self-consciousness will insist on it. There is too much at stake not to do it. The importance to the trade, as a trade, of getting definite recognition for its promotional part in goodwill, of making it the recognized practice to do so, may be gauged by considering the steadying, standardizing effect the criticism of the banking and auditing professions would have on advertising practice.

Taken in a nutshell the argument in this article seems to be in favor of a proposition whereby accountants, bankers and others to whom the preparation and reading of balance sheets is of interest are called upon to recognize and allow the introduction as an asset on the balance sheet of, let us say, a manufacturing corporation, some proportion (to be determined) of the money spent in advertising.

It seems to me that the first thing to do before answering this argument is to ask ourselves the question "What is a balance sheet?" To this we would reply that a balance sheet is an expression of opinion regarding the assets and liabilities of a business at a specific date, bringing out in such opinion the net worth of said business to its owners, be they partners or stockholders. Again, let us ask ourselves "What are assets?" Assets are:

Liquid, and as such represent cash or the readily realizable equivalent of cash,

Advertising an Asset on Balance Sheet

Investments, which also are the equivalent of cash although possibly not readily realizable,

Capital or fixed assets, representing real estate, machinery and equipment, constituting the life force of the business, and from the use and operations of which the profits are derived for the benefit of the owners.

It is under the last named caption that we are asked to consider *Advertising* as an asset, instead of an expense, and thereby to increase (on paper) the profits of the business and the resultant net worth to the owners. One of the arguments set up in favor of this procedure is that the goodwill value of brands, trade-marks, trade-names, trade-characters, etc. are too often lumped confusedly with patterns, licenses, patents, grants, franchises and other entirely different elements which appear in balance sheets as assets. But do two blacks make a white? I think not, and no doubt we would all be glad to see items of trade-marks, patents, etc. eliminated from balance sheets. That also is my opinion with regard to "Advertising" on the balance sheet.

We admit that advertising is valuable just as we admit that personal service of the executives of business is valuable, very often more so than the amounts charged for their salaries. But would we contemplate for a moment setting up an asset to represent the value of the personality of the executive officers to the business? Or would we, for example, in territories where business is largely dependent on the outcome of a good crop, make problematical entries to cover the value of a certain month's sunshine or rainfall or a clear political horizon? Or again, would we every year raise upon the books an asset to represent goodwill, based on the profits for the preceding twelve months? I need not say that the answer to all these queries is no, distinctly no. Then why make an exception in the case of money spent in advertising, the return for which, in future business or sales, cannot even be estimated? It may be an hundred fold, or it may be negligible.

The writer of the editorial under discussion quotes Mr. Dicksee, the English authority, in taking the view that the only excuse for inserting the item of goodwill in accounts is that such an amount has actually been paid by the present proprietor

for the goodwill of the business. That is what Dicksee said; here is what the editorial in question adds to it, "that is to say, in order to make a showing on your books of the investment or residual value of advertising you have got to sell your business."

I do not quite see the connection. If I were in the happy position of selling a business and receiving in the proceeds a substantial sum for advertising or goodwill I do not think I would worry very much how to make the entry on the books. Would you? I think the person who bought the business would have more to worry about than I would, and if he were to call me in professionally after a while and say that he had an item on his ledger for the amount he had paid me for goodwill but did not know how to treat it, I would advise him to charge it off against his surplus as quickly as possible. There would not be so many misleading balance sheets published, especially of large corporations with numerous subsidiary companies, if goodwill, patents and such like items had to be eliminated from the assets, or at any rate segregated in such manner that any layman might know that they represented only problematical value.

In other words, the water in over-capitalizations would have to stand by itself, and we all know that water is physically incapable of doing this; it needs a receptacle which can conveniently hold it.

I am glad to see that the views of accountants are, at any rate, being sought more and more in problems such as the one I have been speaking about, and it is for us, by exchanging our views and arriving at well founded opinions, to justify the confidence placed in us by business men generally.

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EDITORIAL

The Basis of Success

The largest measure of success is always accomplished through organization and co-operation. This, whether it be in general business or in professional pursuits. Organization strengthens the operative force; co-operation welds the interests of the individual members.

Accountancy should be the final, unassailable word in the world of statistical analysis. There should be no possibility of appeal from the professional findings. It should be everywhere so grounded in professional ethics that its advanced standards should be recognized in the legal safeguards provided by legislative enactment.

And it is the fact that, as state after state recognizes the essentials of laws providing for the examination of accountants and the regulation in some measure at least of their practice, as well as through the organization of state societies, this profession is broadening, strengthening, and becoming more and more recognized by the great financial, industrial, mercantile, railroad and other interests of the country.

This has developed from organization and co-operation among the members of this profession who have urged and striven for the safeguarding of its ethics, and who have broadly accomplished this on the basis of these vital factors.

Indifferent individualism will not long stand out against the splendid accomplishments of the higher accountancy.

Right of Fiscal Court to Select Accountant

The court of appeals of Kentucky recently handed down a decision in a case of considerable interest to accountants. While the principle of competitive bidding for accounting work is one that is deprecated by accountants the finding of the court is one that will meet with general approval and we publish herewith the opinion delivered by Judge Carroll. The suit was brought by appellant taxpayers against the members of the fiscal court of Daviess county (Ky.) to enjoin them from paying T. A. Pedley, an accountant who had been employed by the fiscal court for the purpose of investigating the affairs of various county officers. The lower court dismissed the petition and the taxpayers appealed.

It appears from the petition that several accountants presented bids to do the work, in answer to proposals solicited by the court, and that the price at which some of these bidders offered to do the work was a good deal less than the offer made by Pedley, whose bid was accepted. The court holds as follows:

If the fiscal court had the right to employ an accountant for the purpose stated, they had the right to exercise a sound discretion in making the employment and to accept the proposal of that bidder who in their judgment was best qualified to execute the work in a satisfactory manner, although his bid might be higher than the bids of other accountants. Necessarily in matters like this the fiscal court is invested with a large measure of discretion, and under ordinary circumstances this discretion will not be controlled by the courts as it is to be presumed that the fiscal court will act in the discharge of matters under its care in such a manner as to best conserve the interests of the county.

It is further insisted that no tax had been levied to pay the amount the contract with Pedley called for, and therefore the court was without authority to enter into the contract of employment, as it could not expend in this business money raised by taxation under levies made for other purposes. But the order of the fiscal court shows that the appropriation necessary to pay Pedley for his work was appropriated out of the "general fund" of the county, which fund we presume consists of a surplus left remaining from funds appropriated for other purposes after the purpose for which the fund was appropriated had been satisfied. *Whaley v. Com.*, 110 Ky., 154.

The principal question in the case relates to the power of the fiscal court to make the employment. We have written in a number of cases that the fiscal court is a court of limited jurisdiction, and is only authorized to do such things as the statute permits or directs it to do. *Woodruff v. Shea*, 152 Ky., 657, and cases therein cited. And so we must

Editorial

look to the statute for the purpose of ascertaining if the fiscal court had authority to employ an accountant for the purpose stated. In section 1840, defining the jurisdiction of the fiscal court, it is provided, among other things, that it shall have jurisdiction "to regulate and control the fiscal affairs and property of the county," and it seems to us that this right carries with it by necessary implication the authority to examine and investigate the books and accounts and records of the various officers, agents and employees of the county who have the control of or who are charged with the collection or expenditure of the funds of the county arising from taxation or any other source. It might be deemed wise and expedient by the fiscal court to investigate the affairs of one or more of these officers, agents or employees of the county, and this investigation of course the fiscal court could not make without employing some competent person.

The fiscal court is charged by the statute with the duty of looking after the fiscal affairs of the county, and this puts upon it the responsibility that attaches to any other business body, and if it could not, when the occasion seemed to demand it, have an investigation made of the books and accounts and records of any one or more of the officers, agents or employees of the county who have the control of or right to receive or pay out the funds of the county, the court could not, in any proper manner, perform the duty required of it in the management of the fiscal affairs of the county. There is scarcely a business institution in the state of any magnitude that does not have its books examined by some skilled accountant, and there are many good reasons why the fiscal court should be permitted to exercise this character of supervision over the persons charged with the collection or expenditure of the public funds.

We think the judgment of the lower court was correct, and it is affirmed.

Collateral in Kind

Accountants who view mostly the severe and serious side of statistics, unlightened by even a ray of humor will, perhaps, read the following with keen appreciation of its somewhat ridiculous relation to the austerity of the banking business. But it is not fiction by any means.

New York banks, when talking loans with their southern correspondents, generally discuss the subject on the basis of rated paper. But one of the biggest banks in the financial district of this city recently accepted a curiosity in the way of collateral, which latter is, nevertheless, probably as good as anybody's prime paper. The document reciting the list of collateral reads somewhat as follows: "One mouse-colored mule named Jake." Underneath this is another line where the spelling is not

so good, but is no real discount on its value. It reads, "One spotted hefar named Jane." And so the list runs, as an itemized statement of the chattels belonging to the operator of a one-mule plantation down on the Tombigbee, where perhaps today "Jake" is braying out the delight of a finished day's work and "Jane" is roaming along a highway in the simple duty of a growing-up cow.

Such collateral is not unusual locally in cotton-growing districts, but it is a rarity in the big banks of New York.

Proposed Legislation in New York

The committee on legislation of the New York State Society of Certified Public Accountants has had the two bills printed below introduced before the legislature of this state. The first is for an act to amend the code of civil procedure, in relation to privileged communications between certified public accountants and clients. This would add to section 841-*b* of the code of civil procedure a section, to be numbered 841-*c*, to read as follows:

Privileged communications between certified public accountants and clients. A certified public accountant shall not be allowed to disclose a communication, made by his client to him, or advice given thereon, in the course of his professional employment, nor shall any clerk, stenographer or other person employed by such certified public accountant, be allowed to disclose any such communication or advice given thereon. The provisions hereof shall be subject to waiver by the client in the manner provided by section eight hundred and thirty-six of the code of civil procedure.

The second proposed act is to amend the penal law, in relation to false or fraudulent statement by certified public accountants. It would add to article 86 of chapter 88 of the laws of 1909, entitled "An act providing for the punishment of crime, constituting chapter forty of the consolidated laws," after section 957, as added by chapter 593 of the laws of 1913, a new section, to be section 958, to read as follows:

False or fraudulent statement by certified public accountant. Any certified public accountant, who, with intent to deceive, makes, issues or publishes, or causes to be made, issued or published, any statements relating to the financial condition, or to facts affecting the financial condition, of any person, firm, association or corporation, and who knows, or has reasonable ground to believe that any material representation, prediction, or promise made in such statement is false, is guilty of a felony, punishable by a fine of not more than \$5,000, or by imprisonment for not more than three years, or both, and upon his conviction his certificate of qualification to practice as a certified public accountant shall be thereby canceled and revoked and he shall not be allowed thereafter to practice as a certified public accountant.

Income Tax Department

EDITED BY JOHN B. NIVEN, C. P. A.

There have now been published by the Treasury department the general regulations expected for some time past. These contain homogeneously the various regulations and rulings issued in connection with the income tax since the law was promulgated, October 3, 1913. The general regulations have been published by the Treasury department as a supplement to the weekly Treasury decisions, and are entitled "Regulations No. 33." * As the supplement contains a copy of the law the public will find within its pages the complete instrument under which income will be assessed and tax collected. A perusal of these general regulations does not disclose much new matter; but one or two points may be mentioned.

It is noticed that in indicating the deductions and exemptions under paragraph B of the act the interest to be deducted is that paid within the year on personal indebtedness of the tax payer "incurred in the conduct of business." The last six words here quoted do not appear in the act itself, and there seems considerable *doubt* as to whether or not the department can so restrict the intention of the act.

While the act itself states that a return shall be made by each person subject to the tax and having net income of \$3,000 or over, the general regulations provide that any individual whose net income is less than \$20,000, for whom full return has been made by others as withholding agents, shall not be required to make a return. This is a relief from the requirements of the law both just and proper, and it is conceivable that many tax payers will be able to so adjust their claims for exemption that their proper proportion of tax will be paid on their behalf by withholding agents and thus obviate the necessity of their having to make any return.

With reference to the provision in the monthly list returns to be made by withholding agents, that the amount of the tax withheld may be remitted to the collector at the same time as the re-

This supplement may be secured from the local collector or from the Superintendent of Documents, Washington, D. C. The price is 15 cents the copy.

turn is filed, the regulations now state that these amounts are not to be forwarded until notice of assessment is received from the collector. This seems to conform with the further regulation as to the repayment of tax withheld under a claim for deductions filed with the collector, wherein it is provided that the collector will furnish the withholding agent with a statement of the amount of deduction claimed, and the withholding agent will not withhold and pay the normal tax to the extent of the deductions so claimed. It is not clear if it is intended that the tax payer's only source of repayment is the withholding agent, and should he fail to recover the amount from the withholding agent on account of his insolvency or any other cause, whether or not he would also have recourse against the government for the amount due him. To so restrict his rights of recovery would be most inequitable as he has no discretion in choosing his withholding agent.

In order that the records of the JOURNAL may be complete there are published in this issue a number of rulings given out by the department before the general regulations above referred to. Briefly stated the effects of these rulings are as follows:

T. D. No. 1937—January 26, 1914. Rules that corporations are not permitted in arriving at the taxable income for the year 1913 to deduct any portion of the specific exemption of \$5,000 authorized under the corporation tax act.

T. D. No. 1938—January 29, 1914. Extends to April 1 the use of forms 1001, 1003 and 1004.

T. D. No. 1939—January 28, 1914. Is for the instruction of collectors only, but it is interesting to the general public from the fact that it is therein stated that it is contemplated to combine certain forms of certificates in the near future.

T. D. No. 1942—February 3, 1914. Is in reply to numerous letters which have been received by the department as to the placing in Form No. 1040 of income derived from bonds containing the Tax Free Covenant clause and states that such income received prior to November 1 shall be included under column *B* and that such income received subsequent to November 1 shall be included under column *A*, provided no exemption has been claimed. The original text of this ruling was subsequently amended by T. D. 1948 to make the department's intention more clear, and the ruling in its amended form is given in this issue.

Income Tax Department

T. D. No. 1943—February 4, 1914. Gives instructions relative to the returns to be made by fiduciaries. These instructions are along the line generally anticipated by fiduciaries in making up their returns. This ruling also indicates how the income received by an individual from a fiduciary should be entered in Form 1040 and though it may be questioned whether their suggestions that dividends included in the beneficiaries income from the fiduciary should be included among the dividends received from the tax payer's own investments, it is not of much moment provided such information is available to him. One can conceive circumstances, however, in which the beneficiary would have difficulty in obtaining the full details of the fiduciary investments and this provision seems to place additional trouble on the tax payer for no good end. Should the fiduciary estate contain non-taxable bonds a much more serious problem would arise.

T. D. No. 1945—February 7, 1914. Rules that persons having an annual net income less than \$20,000 need not show income derived from dividends or net earnings of corporations on the return. This ruling is declared to amend general regulations No. 33.

T. D. No. 1946—February 10, 1914. States that income derived from interest upon the obligations of special assessment districts created for the improvement of streets, public highways, the provision of sewerage, gas and light and other public purposes shall be excluded in computing net income for the income tax.

T. D. No. 1947—February 12, 1914. Extends the provisions of T. D. 1945 to cover returns made by fiduciaries.

At the end of the treasury rulings in this issue of the JOURNAL p. 222 is printed a copy of form 1042 for making annual list return of normal income tax withheld at the source on salaries, wages, rents and interest which had not been issued by the Treasury department when the February number of the JOURNAL went to press.

TREASURY RULINGS

(T. D. 1937 January 26, 1914)

Corporations are not permitted to deduct from gross or net income for the year 1913 any portion of specific exemption authorized under corporation tax law.—Sec. 38, act Aug. 5, 1909.

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Section 2 of the act approved October 3, 1913, known as the Federal Income Tax law, provides that all corporations, joint-stock companies, and all insurance companies except those specifically enumerated as exempt, shall be subject to the normal tax imposed upon individuals, such tax to be levied, assessed, and paid annually upon the entire net income arising or accruing from all sources during the preceding calendar year.

The provisions of this act apply to corporations which have or may have income arising or accruing on and after March 1, 1913. For the purpose of covering the liability of corporations to special excise tax for the months of January and February, 1913, the provisions of the corporation tax law (sec. 38, act Aug. 5, 1909) were extended, and in subsection S of the income tax law it is provided that the net income for these two months shall be ascertained in accordance with the provisions of subsection G of section 2 of the act of October 3, 1913; that is, in the same manner as the net income for the remaining 10 months of the year is ascertained.

In the subsection G, just cited, all items or charges against income, which constitute allowable deductions from gross income, are specifically set out. No provision, either express or implied, is made in this subsection or elsewhere in the act for the allowance of all or any portion of the specific exemption (\$5,000) allowed under the corporation tax law. As applied to the months of January and February, 1913, the income tax law in effect amends the corporation tax law by eliminating the specific exemption previously allowed, and provides that the tax for that period shall be measured by the net income ascertained according to the rule set out in subsection G of the later act. (See second proviso in subsection S, act Oct. 3, 1913.)

The third proviso of subsection S also provides that—

For the year 1913 it shall not be necessary to make more than one return and assessment for all taxes imposed * * * by way of income or special excise.

The net income for both kinds of taxes and for both periods of the year being ascertained in exactly the same manner, but one return covering the entire calendar year 1913 is required. That return will show the entire net income ascertained in accordance with the provisions of the income tax law, and no specific exemption whatever being authorized, such net income as returned for the entire year will be the amount upon which the tax is computed.

(T. D. 1938 January 29, 1914)

Extension of time to April 1, 1914, for the use of Forms 1001, 1003, and 1004, as provided in T. D. 1907 of November 26, 1913.

Notice is hereby given that Forms 1001, 1003, and 1004, as adapted

Income Tax Department

to the use of foreign organizations, foreign partnerships, and foreign fiduciaries, when properly filled in and signed, and giving the information required by regulations, may be accepted by debtors or withholding agents until March 31, 1914.

(T. D. 1939, January 28, 1914.)

Blank forms of certificates and other forms required in connection with the collection of income tax and making of returns by taxpayers will be furnished on application to the Commissioner of Internal Revenue. Forms may be printed by corporations and others, provided they conform strictly to department requirements as to size, print and contents. In making requisition on the department for forms no more should be requested than the absolute needs of the office make necessary.

You are instructed that the department will furnish blank forms of certificates and other forms required to be used in connection with the collection of the income tax and the making of their returns by taxpayers to such parties as may make application for the same. Private corporations and others desiring to have these forms printed for themselves may do so if they will strictly observe the requirements of the department as to size, print and contents of the forms and certificates as prescribed by the regulations.

In pursuance of the desire of the department to furnish every possible facility to aid taxpayers in complying with the law, requisition should be made for such quantity of the various forms as may be found necessary in each collection district, and these forms will be forwarded immediately upon application. Attention is called, however, to the fact that a large stock of these forms should not be accumulated in any office, and that for the present, particular caution should be exercised so as not to make requisition for more than the absolute needs of each office. It is contemplated that in the near future a combination of certain forms of certificates may be arranged for, and these consolidated or combined certificates will be furnished as soon as practicable. When such combined certificates shall be furnished, the use of the older or original certificates—that is, those now in use—should be discontinued at the earliest possible date.

(T. D. 1942 February 3, 1914)

(Amended by T. D. 1948 February 12, 1914)

Income tax ruling as to income derived from bonds containing "tax-free covenant clause," and how same may be returned on Form 1040 when *exemption is not claimed* at the source.

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LETTER TO COLLECTORS

This office is in receipt of numerous letters asking whether income, tax on which is *paid or to be paid at the source*, although not *withheld* at the source, can be placed in column A, page 2, of Form 1040, and in reply to this inquiry you will advise as follows:

The stipulation in bonds whereby the tax which may be assessed against them or the income therefrom is guaranteed is a contract wholly between the corporation and the bondholder, and in so far as the income tax law applies the government will not differentiate between coupons from bonds of this character and those from bonds carrying no such guarantee. The debtor corporation, or its duly authorized withholding agent, will be held responsible for the normal tax due in such cases when no tax has been withheld and no exemption claimed.

Income paid by "debtors" from March 1 to November 1, 1913, shall be included in the return of the individual (under column B, page 2, of Form 1040) as income upon which the normal tax of 1 per cent has not been withheld and paid at the source.

Income received by individuals between November 1 and December 31, 1913, upon which the normal tax has been withheld at the source shall be included in their annual return (under column A, page 2, of Form 1040) as income upon which the tax has been withheld.

(T. D. 1943 February 4, 1914)

Instructions to collectors relative to fiduciaries and returns to be made by them on Form 1041.

T. D. 1908 provides that all fiduciaries shall on or before March 1 of each year, when the annual interest of any beneficiary in the income of the estate or trust is in excess of \$3,000 (\$2,500 for the year 1913), make and render a return of the income of the person or persons (the beneficiaries) for whom they act to the collector of internal revenue of the district in which the fiduciary resides.

Where a decedent died after March 1 in the year 1913, and from March 1 up to the date of his death had a net income of \$2,500 or more, the fiduciary (i. e., the executor or administrator) should make a return for the decedent on Form 1040, and the income tax, both normal and additional, shown to be due thereon will be a debt against the estate of the decedent. The same principle will apply to subsequent years if the net income of the decedent from January 1 to the date of his death amounts to \$3,000 or more. No other return is required to be made by the fiduciary until the settlement of the estate has reached the stage when the beneficiaries thereof and their respective interests in the *income* derived from the estate are determinable, and then the fiduciary is required to file a return on or before March 1 of each year, as prescribed by the regulations.

Income Tax Department

The fiduciary will enter on page 2 of Form 1041, under the appropriate heads, all income accruing to the beneficiaries of the trust or estate from March 1 to December 31, 1913, inclusive; but the interest derived from the obligations of a State or any political subdivision thereof and the obligations of the United States or its possessions is not to be included.

The fiduciary will enter on page 3 of Form 1041 for the year 1913 five-sixths of the deductions allowable under paragraph B of the law, and on line 1 it will be proper for the fiduciary to enter all legitimate expenses incurred in administering the estate or trust. If the fiduciary holds and rents business or residential property and pays insurance, water rents, commissions for the collection of rents, or any other necessary expenses in managing the estate or trust, it will be proper to enter same on line 1 as an allowable deduction.

The amount to be shown on page 1, line 3, will represent the total amount of income accruing through the fiduciary to the beneficiaries of the estate or trust which is subject to the normal tax, and when the interest of any one beneficiary in this amount from November 1 to December 31, 1913, inclusive, was in excess of \$3,000, whether distributed or not, the fiduciary was required to withhold and pay the normal tax on the whole \$3,000 and excess thereof, unless the beneficiary filed with the fiduciary Form 1007, as prescribed by the regulations, claiming exemption under paragraph C, and in that event the fiduciary was only required to withhold and pay the normal tax on the amount in excess of the exemption claimed.

T. D. 1906 prescribes that when fiduciaries make their annual return they shall give the name and full address of each beneficiary and the share of income to which each may be entitled, which information shall be given on page 1 of Form 1041. In the column "Amount of income paid or accrued to beneficiaries" should be entered the respective interest of the beneficiary in the amount of income as shown on page 1, line 3.

When the interest of any beneficiary in the amount of income subject to the normal tax, as shown on Form 1041, page 1, line 3, is in excess of \$3,000, and the same was paid to the beneficiary within the period from November 1 to December 31, 1913, both dates inclusive, the fiduciary was required to *withhold and pay the normal tax* as prescribed by the regulations, and the information required should be given on Form 1041, page 1, giving the name and full address of each beneficiary, the amount of income paid or payable to each beneficiary (this amount would be the beneficiary's interest in the amount of income subject to the normal tax as shown on line 3), the amount of exemption claimed under paragraph C (if any), the amount of income on which normal tax should be withheld, and the amount of tax withheld, all to be given in the respective columns in the order named.

A fiduciary acting for a minor or insane person who had a net income of \$2,500 or more for the year 1913 will make the return for his ward on Form 1040 and will not be required to file a return on Form 1041, unless he has more than one ward by reason of the same estate or trust; then in that event a return will be required on Form 1041, and a separate return

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on Form 1040 for each ward having a net income of \$2,500 or more for the year 1913.

The income accruing or paid to a beneficiary through a fiduciary may be composed in part of *dividends*, or income upon which the normal tax has been *withheld and paid or to be paid at the source*, or income derived from the obligations of a state or any political subdivision thereof or from the obligations of the United States or its possessions (income from obligations of a state or any political subdivision thereof and from the obligations of the United States or its possessions is not subject to the tax and should not be included). If a beneficiary has other income which, added to the income accruing to him through his fiduciary, gives him a net income of \$2,500 or more for the period from March 1 to December 31, 1913, inclusive, he should make a return of his gross income on Form 1040, as required by the regulations.

To illustrate: If a fiduciary's gross income was \$10,000, derived from the following sources:

| | |
|--|--------------------|
| 1. Interest upon the obligations of the United States | \$ 1,000.00 |
| 2. Dividends on stock or net earnings of corporations | 2,000.00 |
| 3. Interest from bonds containing "tax-free covenant clause," upon which the fiduciary did not claim any exemption at source and which he entered on Form 1041, on page 2, column A, as income on which normal tax was withheld | 2,000.00 |
| 4. Income from rents, etc. | 5,000.00 |
| | <u>\$10,000.00</u> |

the fiduciary's return on Form 1041 would show as follows:

| | | |
|---------|--|--------------------|
| Page 2. | Line 3, column B, amount of rents | \$ 5,000.00 |
| | Line 5, interest from bonds, "tax-free clause," column A | 2,000.00 |
| | Line 10, dividends | 2,000.00 |
| | Aggregate total of gross income | <u>\$ 9,000.00</u> |
| | (No entry of interest on United States bonds, \$1,000.) | |
| Page 3. | Line 1, necessary expenses actually paid in carrying on business, including compensation of fiduciary, water rents, insurance, etc. | \$ 450.00 |
| | Line 3, taxes paid | 400.00 |
| | Line 6, actual repairs made on building, or amount al- lowed for wear and tear | 150.00 |
| | Line 7, dividends not subject to normal tax | 2,000.00 |
| | Line 8, amount of income on which normal tax has been deducted and withheld at source, bonds with "tax- free clause" | 2,000.00 |
| | Total deductions | <u>\$ 5,000.00</u> |
| Page 1. | Line 1, gross income | \$9,000.00 |
| | Line 2, total deductions | <u>5,000.00</u> |
| | Line 3, amount of income due beneficiary, which is sub- ject to normal tax | \$ 4,000.00 |

Income Tax Department

The beneficiary has filed with the *fiduciary as a withholding agent* a claim for exemption under paragraph C for \$2,500 (exemption of single person for 1913), and the return on Form 1041 would show on page 1, in addition to the foregoing entries, the following:

John Doe, 76 B street, New York City

| | |
|---|-------------|
| In third column, amount of income paid or accrued to beneficiary | \$ 4,000.00 |
| In fourth column, amount of exemption claimed | 2,500.00 |
| In fifth column, amount of income on which fiduciary is liable to tax | 1,500.00 |
| In sixth column, amount of normal tax withheld | 15.00 |

In the foregoing illustration the beneficiary, in his return on Form 1040, would make no return of item 1, interest on United States bonds. Item 2, dividends, would be entered on page 2, line 11, and for the purpose of calculating the normal tax would be an allowable deduction on page 1, line 4. Item 3, interest on bonds, would be entered on page 2, line 7, column A, and for the purpose of calculating the normal tax would be an allowable deduction on page 1, line 5. Item 4, rents, would be entered on page 2, line 7; \$1,500 in column A, and \$2,500 in column B (exemption of \$2,500 claimed and no tax withheld on this amount). This would show—

| | |
|--|-------------|
| Income received from fiduciary subject to be returned on Form 1040 | \$ 8,000.00 |
| Deductions and exemption allowable in calculating normal tax | 8,000.00 |
| No normal tax due, it having been paid at the source by the fiduciary as shown by his return on Form 1041. | |

In making the foregoing entry on Form 1040, on line 11, there should be written just above the printed heading, "Amount received from fiduciary," and the amount should be entered in the appropriate column.

No illustration is given of income accruing to the beneficiary from *other sources*, an illustration of this not being deemed necessary, as such income is entered in the usual way.

(T. D. 1945 February 7, 1914)

Regulation relative to exclusion of income derived from dividends or net earnings of corporations, joint-stock companies or associations, and insurance companies by persons subject to the normal tax only in computing their net income for the taxable year.

Referring to that provision of the income-tax law which reads as follows:

Provided further, That persons liable for the normal income tax only, on their own account or in behalf of another, shall not be required to make return of the income derived from dividends on the capital stock or from the net earnings of corporations, joint-stock companies or associations, and insurance companies taxable upon their net income as herein-after provided—

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you are informed that returns of individuals, when such individuals are subject to the normal tax only, need not include the income derived from the dividends or net earnings referred to above. When individuals are subject to the additional tax, such income derived from said dividends or net earnings must be shown on the return.

Persons having an annual net income of \$3,000 or more, including the income derived from dividends or net earnings of corporations, etc., but whose total net income is less than \$20,000, and whose net income, exclusive of the income derived from dividends or net earnings of such corporations, etc., is less than \$3,000 for the taxable year (\$2,500 for the year 1913), shall not be required to make a return of annual net income.

Returns which have been or may be received from persons subject to the normal tax only, in which such dividends are included and deducted, need not be changed to meet the provisions of this regulation.

All previous rulings of the department, including the general regulations No. 33, are amended accordingly.

(T. D. 1946 February 10, 1914)

Special assessment districts created under the laws of the several States for public purposes, such as the improvement of streets and public highways, the provision for sewerage, gas, and light, and the reclamation, drainage, or irrigation of bodies of land, and levee and school districts are held to be political subdivisions of a state.

Referring to paragraph B, section 2, of the income-tax law, which reads as follows:

That in computing net income there shall be excluded interest upon the obligations of a State or any political subdivision thereof—

you are informed that under date of January 30, 1914, the honorable the Attorney General held that special assessment districts created under the laws of the several states for public purposes, such as the improvement of streets and public highways, the provision for sewerage, gas, and light, and the reclamation, drainage, or irrigation of bodies of land within such special assessment districts when such districts are for public use, are political subdivision of the state within the meaning of the above proviso.

It is held that the term "political subdivision" includes special assessment districts or divisions of a state created by the proper authority of the state acting within its constitutional powers and under its general laws for the purpose of carrying out a portion of those functions of the state which by long usage and inherent necessities of government have always been regarded as public.

Levee and school districts when lawfully created under the authority of the state and which are authorized by the laws of the state to levy a tax to meet the obligations of such districts are also held to be political subdivisions of a state within the meaning of the income-tax law.

Income Tax Department

The income derived from interest upon the obligations of all such public districts shall therefore be excluded in computing net income for the income tax.

This decision supersedes T. D. 1910.

(T. D. 1947 February 12, 1914)

Extending T. D. 1945 to cover returns made by fiduciaries in their fiduciary capacity.

LETTER TO COLLECTORS

You are advised that the provisions of T. D. 1945—in matter of exclusion of dividends or net earnings of corporations, joint-stock companies or associations, and insurance companies, by persons subject to the normal tax only, in computing their net income for the taxable year—are extended to cover such returns by fiduciaries.

To make clear any doubt on the subject, the provisions of T. D. 1945 are hereby specifically extended to include returns made by fiduciaries as such.

UNITED STATES INTERNAL REVENUE

From 1942:

The income to be made the subject of this return does not include dividends on capital stock or net earnings of corporations, joint-stock companies, etc., subject to the tax or income derived from interest upon bonds or mortgages, or deeds of trusts, or other similar obligations of corporations, joint-stock companies, etc., or from interest upon bonds, mortgages, or dividends of foreign corporations.

Filed by **for the year 191**
(Name of debtor or withholding agent)

To be made in duplicate to the Collector of Internal Revenue for the District in which the debtor or his duly appointed withholding agent, as the case may be, is located, on or before the first day of March, showing the names and addresses of persons who have received salaries, wages, rent, etc., as above described, in excess of \$1,000, on which the normal tax of 1 per cent has been deducted and withheld during the preceding calendar year.

I (we), _____ of _____
 the _____ of _____ located at _____

do solemnly swear (or affirm) that the following is a true and complete return of all salaries, wages, rent, and other fixed and determinable annual gains, profits, and income in excess of \$5,000 as above described, which were paid (or were payable) to each of the persons listed herein, and on which the normal tax of 1 per cent was deducted and withheld during the year stated, and there are herewith enclosed all certificates showing deductions and deductions with respect to said income.

[illegible]

To
District of day of 191.....

Signed:
.....
Notary Public in and for the State of New York
My Comm. Expires on or before

NOTE A.—Withholding agents may, if they so desire, pay at the time this list is filed, to the Collector of Internal Revenue with whom the list is filed, the amount of tax withheld during the year for which the list is made.

Students' Department

EDITED BY SEYMOUR WALTON, C. P. A.

In the development of accounting the first business transaction consisted merely in the exchange of one article for another—otherwise barter. Anyone having more of a certain commodity than he needed for his personal use, or having less than he needed of some other commodity, would seek out some one whose condition was the reverse of his, and the two would arrange an exchange, (or barter), by which the deficiency of each was made good out of the excess of the other. This condition could exist only in the aboriginal state of social affairs. As the wants of individuals were few at that stage of existence, and as those wants varied constantly with each individual, there could be no stable conditions of trade. Each barter was determined by the temporary needs of the parties engaging, and was completed as soon as the commodities changed hands.

Sometimes an individual might have an excess of some one commodity which he was willing to dispose of, but might not be at the moment in need of any other commodity, or he might not be able to at once find any one from whom he could obtain a commodity which he was desirous of possessing. Under such conditions he would be willing to part with his own commodity if he could receive for it something for which there was a steady demand, so that he would be certain to have an article which he could barter for the articles which he might need at any time in the future. Gradually specific things were adopted as recognized standards, such as beaver skins among the Indians, and tobacco among the early settlers of Virginia. As this was merely an extension of the direct barter principle, there was still no necessity of keeping records of transactions or accounts.

As it was inconvenient to keep on hand a large quantity of actual merchantable commodities, except for those dealing regularly in them, it was recognized early that something should be adopted that was easily portable, virtually indestructible, and was produced in such small quantities as to be practically of a stable value. Only two commodities came near to fulfilling these conditions, gold and silver. It is not definitely known when these metals were adopted as standards of value, but it certainly was before the days of Abraham. Still, the world had not advanced beyond the barter stage in reality, since gold and silver were not accepted in exchange for surplus commodities because they were desirable in themselves, but because they represented the power to acquire other commodities when needed. Therefore, there was still no necessity of making records or of keeping accounts.

THE ORIGIN OF CREDIT

As social conditions became more complex, and the needs of men more

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extended, it would often happen that a person who did not at the time possess anything which he could offer in exchange, or any money with which he could purchase it, would desire to acquire some commodity. If there was a reasonable certainty that within a given time he would acquire the means with which to discharge his obligation he would have little or no difficulty in finding some person with such an excess of the desired commodity on hand that he would be willing to part with it, and wait a reasonable time for the equivalent in money or goods. The first transaction of this character marked one of the most important epochs in the history of the world, as it introduced an element into the relations of men to each other which became indispensable in all business transactions.

As the exchange of commodities was now complicated by the delivery of goods by one party to the transaction, with a mere promise of the equivalent by the other party, it became necessary to make some record of the deferred obligation. At first this consisted of a memorandum on a board, or on the back of a door, made with a piece of chalk. When the debtor settled, the record of his indebtedness was cancelled by the simple expedient of wiping it out. This crude method has left its mark on our language in the expressions, "chalk it up" and "wiping out his debts." The introduction of credit thus necessitated some kind of record of a transaction, but the need of regular accounts of any character did not develop until the transactions became too numerous to handle in this crude way.

THE FIRST ACCOUNT BOOK; THE DAY BOOK

In order to keep the record of credit transactions in a convenient form for reference and in a shape that would be permanent until they were settled, the expedient was adopted of making an entry in a memorandum book. This entry would contain the date, the name of the party, a description, and the price of the goods. As the entries followed each other day by day, this book was given the name of the daybook. As a merchant who sold on credit would naturally also buy on credit, he would enter in the daybook a memorandum of such purchases, but would make no discrimination between the records of his sales and purchases by means of separate columns for debits and credits. The only distinction between a sale and a purchase would be that one would show goods sold to, and the other goods bought of, some person. In other words, the daybook would contain merely a memorandum list of the various transactions. Whenever any one owing the merchant money came in and paid, the merchant found the record of the sale in the daybook and wrote the word "paid" across it, and thus closed the account. Entries not thus cancelled constituted his unpaid accounts receivable. As he, in a similar manner, cancelled the notation of the bills he himself owed, he easily found the amount of his unpaid accounts payable by making a list of the uncanceled items.

It might seem as if such a crude arrangement would be adapted only

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to a person doing a small business mostly for cash with few credit sales, but such memorandum methods are not uncommon in business of considerable volume. The writer knew of a man who did a large business in the sale of books by mail. His invoices were made in duplicate and were numbered consecutively. When he shipped books to a customer he sent the original invoice. The duplicate was placed in the left-hand drawer of his desk, all the invoices in that drawer being kept in numerical order. When the customer remitted the duplicate invoice was found, marked "paid," and filed. No other record was kept, nor was credit made to "sales" or to "merchandise." In the same way, when he received an invoice for goods purchased he placed it in alphabetical order in the right-hand drawer of his desk, until he was ready to pay it. When paid it was filed in an ordinary letter file. Whenever he wished to know how much his customers owed him, he could ascertain by listing the invoices remaining in the left-hand drawer, and a similar list of invoices in the right-hand drawer would give him the amount of his unpaid obligations. As his sales were always on short time he claimed that this method was as effective as an elaborate system of sales records and of accounts in a customers' ledger.

SINGLE ENTRY AND LEDGER SYSTEMS

An analysis of these crude methods shows that all the records, such as they are, take into consideration only individuals from whom or to whom money is owing for goods sold or purchased. There is no attempt at keeping record of the amount of sales or of purchases. Neither is any record made of permanent investments in furniture, fixtures, horses, wagons, or other material articles. Such articles would always be where they could be seen at any time. In other words the records are only of those articles likely to be forgotten—the amounts due from or to persons. As each entry consists only of a charge or a credit to some individual, without any offsetting credit or charge to "merchandise" or similar account, this method of keeping accounts has been given the name of "Single Entry."

As long as the transactions were comparatively few the daybook was the only book essential to complete information of the debts due to or from the business. A glance through its pages would show the accounts not cancelled, and therefore still unpaid. As transactions increased in number, and especially when customers made numerous purchases at different times, without paying for previous ones, or when they made partial payments of round amounts, not applicable in total to specific purchases, or when goods were returned by customers or to creditors, it was not only a difficult task to hunt up all the scattered entries in the daybook, but there was also great danger of missing some item involved in a settlement. It was necessary to devise a plan by which transactions with each individual customer or creditor could be separated from those with others, so that the amount due from or to him could be ascertained with no trouble.

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To accomplish this the ledger was evolved. Each customer was given a page in this book, on which was transcribed from the daybook a memorandum of each item bought by or from him. As there were no offsetting entries there was no occasion to keep this ledger in balance. When an account was settled it was sufficient to mark "paid" across it, without specifying how much was paid. Even when a cashbook was adopted and payments were posted from it to the ledger any settled account in the ledger would be ruled off whether the two sides of the account were alike or not. That is, if a customer had been charged with \$155 for merchandise bought, and had been allowed 2% discount for cash and a rebate of \$5 for damaged goods, his payment of \$147 would be credited to him, and the account ruled off as settled, in spite of the fact that there was still \$8 apparently due. It would have to be ruled off, or cancelled in some way, to prevent the apparent balance from continuing to appear against him. All the single-entry man cared to know was that he had no further claim against the customer for that particular lot of merchandise.

The ledger therefore was merely an extension of the idea contained in the daybook, the information being classified under the names of the individuals instead of being arranged according to dates. The purely memorandum character was continued. If accounts were opened, except those with individuals, these also were only memoranda made to obtain some specific information. If the merchant did not own his horses and wagons he might keep a memorandum on his ledger of the amounts he paid to outside teamsters or expressmen, so that he would know the total cost yearly, and thus be able to determine whether it would pay him to own his horses and wagons. This account would have absolutely no meaning except as furnishing the desired information. It could not be used in ascertaining the profit or loss of the business, because it would have no relation to any other element of the business, unless he also kept accounts with all the other elements, in which case the books would be kept in double-entry, and have entirely lost their single-entry character. Therefore at the end of the year any account of this nature would be ruled off and ignored.

One class of items of which a single-entry man would naturally desire to keep a record would be the amounts of money which he himself had drawn out of the business, either in cash or by the payment of his personal bills. This record would be the account of the business with himself as a person, and would therefore, not be an exception to the above statement that single-entry accounts are kept only with individuals, the amounts of whose transactions are likely to be lost sight of unless some record of them is made. As he would not be apt to forget the amount of his original investment, a single-entry man would not keep an account with the capital he had in the business.

THE CASHBOOK

Contrary to what might be expected, a cashbook would probably be the last book that a single-entry man would adopt. As long as his

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business was so small that he himself could handle all the cash, and could turn to the daybook or ledger and mark a paid account as settled, he would not need a record of money received or paid out. He would know that any money received had gone into the cash drawer, and that any money taken out had been used for some legitimate purpose, and that would be all that he would care to know. When the business had so increased that it became necessary for others besides himself to receive and disburse money it would become essential that a record be kept of cash that came in and went out in order to determine whether money actually on hand correctly represented the difference between total receipts and total payments. One side of the book was devoted arbitrarily to receipts and the other to payments, the excess of the receipt side over the payment side (in other words the balance) being the amount of money that should be on hand.

The cashbook was the first book in which the balance idea appeared, and it is the only one in single entry in which a balance is possible. That is, because without knowing it the single-entry man was really using a double-entry book. As ledger accounts were kept only with individuals, the entries in a single-entry cashbook would pay no attention to the names of any impersonal accounts. They would be simply a record of money received or paid, such as "cash sales for the day," "paid rent," "paid for coal," and so on.

SINGLE ENTRY IN ACTUAL USE

It must not be supposed that the subject of single-entry can be dismissed as unimportant because it is used only by a limited number of small retail merchants. Every accountant of experience has doubtless encountered a number of large concerns where books were kept in single-entry, because they were begun that way in the day of small things and the proprietors have not known enough to make a change when the business needed better methods. Two instances, in Chicago, relate to manufacturers who were among the largest in their respective lines in that city. One had a large factory, employing a large force, and making two different classes of metal goods. His affairs were further complicated by the fact that he owned several apartment buildings and a number of city lots which he was selling on partial payments. He had a fairly good set of accounts with trade debtors and creditors, but all other records of his business were confined to cashbook entries of the receipt and payment of money, without specifying particulars. Money would be shown as received from some one not a customer, but whether it was for rent of an apartment, for payment on a lot, or for the repayment of a loan was not indicated in any way. An amount would be paid to a coal company, but there would be nothing to show whether the coal was used in any one of the apartment buildings or in the factory. As both the proprietor and his bookkeeper died in the same week, accountants who were called in were confronted with a puzzle that it was impossible to solve. Many items could be traced and posted to proper accounts, but

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there were many others about which nothing was known, not even the identity of the individuals named. It was discovered that there were notes payable, for several thousands of dollars each, held by relatives and the superintendent of the factory, of which there was no record on the books. The only thing the accountants could do was to have an accurate inventory taken, which, with the list of accounts receivable and payable and the discovered notes, was made the basis of an assets and liabilities statement on which a proper set of double-entry books could be opened.

There are certain classes of accounts which it is proper to keep in single-entry, namely, those concerned only with the collection of assets and the disbursement of the proceeds to those entitled to them. Such transactions involve merely the handling of cash received and a proper disposition of it. An accurate cashbook must be kept, as is usually the case in single-entry accounts. If assets are scheduled with a space after each entry, in which to note how much was realized from it, and a similar schedule is made of the liabilities, with a notation of how much has been paid on account of each, there is sufficient information from which to make up the report of a receiver for a small business in bankruptcy, or that of the executor of a small estate, provided the receiver or the executor does nothing but realize on the assets and pay over the proceeds to the creditors or the heirs. If affairs are complicated by the necessity of carrying on a business for some time before it can be wound up there would arise a need for more extended accounts of a double-entry character. If no such complications exist there is no necessity for elaborate double-entry accounts, although there would be no objection to them if they were desired.

DETERMINING PROFIT OR LOSS

In spite of the fragmentary nature of single-entry accounts it is not a difficult thing to ascertain whether a business, whose accounts are kept in this way, has made or has lost money in a given period, and how much that profit or loss may be. It needs no argument to convince a man who has neither put into nor withdrawn money from the business during the year, that he has made a profit if he finds that the business is worth more at the end of the year than it was at the beginning. There is no other way in which the increase in value could have been derived than by the making of a profit exactly equal to the increase. In the same way, a decrease in value must be caused by losses of the business. Therefore, to ascertain the profit or loss of a business for a year, by the single-entry method, it is necessary to know the value of the business at both the beginning and the end of the year. This value is represented by the total available or real assets, less the total actual liabilities. As the ledger contains only the record of amounts due to and from persons the only assets obtainable from it would be the open accounts of customers, and the only liabilities the open accounts of creditors. Other assets, such as notes receivable, horses and wagons, furniture, fixtures, etc., would

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have to be obtained from some other source, either by observation or from memory. Notes payable, unpaid wages, etc. would also be ascertained outside of the books. When all the assets are listed and the total of the liabilities is deducted from them, the result is the net worth of the business—that is, what it would be worth if all its debts were paid. The comparison of the net worth at the end with the net worth at the beginning will show either an increase owing to profits or a decrease owing to losses.

STATEMENT OF CONDITION ; PROPRIETOR'S ACCOUNT

The schedule of assets and liabilities showing net worth is a "statement of condition," or an "assets and liabilities statement." It is not a "statement of affairs," for that term is used in a technical sense of a special form of statement in which net free assets are compared with unsecured liabilities. It is not a balance sheet, because that term is always defined as a schedule of assets and liabilities as contained in the ledger. Since a single-entry ledger does not contain any impersonal accounts it is impossible to prepare a balance sheet from it. It may seem as if this were a distinction that is hardly worth making, but it is such close distinction as this which distinguishes the clear thinker from the superficial one. In accountancy it is especially important that the terms used be clearly defined and that they should be always employed to designate specific things and nothing else.

Since the profit or the loss of a business the accounts of which are kept in single-entry is ascertained by the comparison of the net worth at different periods, the action of the proprietor as to the contributing of new money to the business or the withdrawing of money from it becomes an important element. If he has put in additional assets it is manifest that the net worth will have been increased by an amount which is not a profit, while if he has withdrawn money he will have decreased the net worth by an amount which is not a loss. Therefore, when the increase or decrease of net worth is determined it is still necessary to inquire whether the proprietor has put in or has withdrawn money. If he has put in money the effect is the same as if the net worth at the beginning had been that much greater. Therefore the amount put in should be added to the net worth at the beginning, before it is compared with the net worth at the end. If he has drawn out money he has reduced the net worth at the end by reducing his cash on hand which is part of his net worth. The amount of his withdrawals should, however, not be added to the net worth at the end because that net worth is a statement of his net assets. Adding the withdrawals to it would be treating those withdrawals as an asset, which would not be true in single-entry, which takes into consideration only real, tangible assets. As the withdrawals have diminished the net worth at the end they have also diminished the increase in net worth, and have, therefore, correspondingly reduced the indicated profits. As the withdrawals are not in themselves losses it follows that they must be withdrawn profits. The profit of the business

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is thus seen to consist of two elements—the increase in net worth, which is the profit left in the business, and the withdrawals of the proprietor, which is the profit drawn out of the business, the two together being the total profit. There is no other way to explain the increase of net worth and the drawings of the proprietor except that the sum of them represents the total profit. The word “sum” is here used as in algebra, for if the business showed a decrease in net worth, and the proprietor had drawn out a larger amount than the decrease, there would still be a profit shown of the algebraic sum of the withdrawals minus the decrease in net worth.

AN ILLUSTRATION

A simple illustration will make clear the method of ascertaining the profit in single entry by the Assets and Liabilities plan. Suppose John Smith possessed the following assets on the first of January:

| | | |
|---------------------------------|--------------|--------------|
| Land and buildings | \$ 20,000.00 | |
| Machinery | 15,000.00 | |
| Furniture and fixtures | 1,000.00 | |
| Horses and wagons | 2,000.00 | |
| Merchandise inventory | 6,000.00 | |
| Customers' accounts | 25,000.00 | |
| Cash | 3,000.00 | \$ 72,000.00 |
| | | <hr/> |
| And owed to his creditors | | 23,000.00 |
| | | <hr/> |
| His net worth would be | | \$ 49,000.00 |

On December 31 of the same year his statement of condition was as follows:

| | | |
|------------------------------|--------------|--------------|
| Land and buildings | \$ 20,000.00 | |
| Machinery | 16,000.00 | |
| Furniture and fixtures | 1,000.00 | |
| Horses and wagons | 2,000.00 | |
| Merchandise inventory | 8,000.00 | |
| Customers' accounts | 27,000.00 | |
| Cash | 4,000.00 | \$ 78,000.00 |
| | | <hr/> |
| Less due creditors | | 21,000.00 |
| | | <hr/> |
| Net worth | | \$ 57,000.00 |

During the year he has drawn out \$3,000.00 for his personal use. The profits of the year are found in this way:

| | |
|---|--------------|
| Profits of the year (found in this way): | |
| Net worth, end of the year | \$ 57,000.00 |
| Net worth, beginning of the year | 49,000.00 |
| <hr/> | |
| Increase in net worth (profit left in business) | \$ 8,000.00 |
| John Smith's drawings (profit drawn out) | 3,000.00 |
| <hr/> | |
| Total profit for year | 11,000.00 |

To show why the amount drawn out by John Smith must be added to the increase in net worth to find the total profits, it is only necessary to assume that he had not drawn anything. In that case his cash would

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be \$7,000 instead of \$4,000, and his net worth at the end would have been \$60,000, and the increase in his net worth, (and therefore his profits), would have been \$11,000, the same as resulted from adding his drawings to the increase in his net worth.

UNCERTAINTY OF SINGLE ENTRY; COMPARATIVE BALANCE SHEETS

As there was no method in single-entry by which the correctness of the statement of assets and liabilities could be proved, as can be done by the balance sheet of a double-entry system, the conclusions drawn from the statement could never be relied on. An asset or a liability might be forgotten or be taken into the account twice and there would be no way to discover that an error had been made. An anecdote is related of an old Quaker merchant whose profits, determined in this way, amounted to about \$2,000 more than he had expected. On the strength of this showing he indulged in some unusual extravagancies. Not being quite satisfied, he went over the statement once more, with the result that he called out to his clerk, "John, John, dost thee know what thee hast done? Thee hast added up the year of our Lord among the assets." It is not the only instance of questionable items being carried as valid assets, but in double-entry, we have at least the satisfaction of knowing what these are, or where they are likely to be found.

The single-entry principle of comparing net worth at one time with that at another is often used in double-entry accounts, by instituting a comparison between the balance sheet at the end of one year with the balance sheet at the end of the preceding year. The assets of the two dates are set in parallel columns, followed by two other columns—one for increases and the other for decreases of the second date as compared with the first—the difference between the totals of these two columns being the net increase or decrease in assets. A similar treatment of the liabilities will show the net increase or decrease of these items. A comparison between the net increase or decrease of assets with the net increase or decrease of liabilities will exhibit the exact profit or loss of the period, provided the proprietor has not withdrawn any of the profits in the meantime. If he has an adjustment must be made, as in single-entry.

This is a favorite form of statement with some persons, especially with attorneys. The accountant is not so apt to use it, unless he wishes to show that a concern has been increasing its fixed assets at the expense of its working capital. The difference between this method of arriving at the profits in both single and double-entry is that in single-entry there is no way to prove its accuracy, while in double-entry its correctness is proved not only by the equality of the debits and credits of the balance sheet, but also by the corroborative evidence of the profit and loss account.

By the assets and liabilities method of ascertaining profit or loss in single-entry the amount of the profit or loss made may be determined, but usually there is no way to find out how the profit or loss was brought about. In double-entry an account is kept with every element of the

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business, and these elements can be so analyzed as to show clearly which element tended to increase and which to decrease the final profit. If the cash account of a single-entry set of books is kept in such way that it can be easily ascertained how much money was received from customers and how much was paid to creditors during the year, and some information can be gained from it as to the expenses and wages paid, it is possible to make up from these figures, together with the inventories and personal accounts, a statement of profit and loss on the double-entry plan which will give a fair idea of the course of the business, its total sales and purchases, and the cost of the goods sold. This is brought out in a problem in the Illinois examination of May, 1913, as follows:

AN ILLINOIS EXAMINATION PROBLEM

A "single-entry" set of books for 1912 are sent to you with an order to state a profit and loss account for the year and a balance sheet at December 31. The starting capital was \$ 34,500.

| | | | |
|---------------------------------------|--------------|-------------|-----------|
| The accounts receivable Jan. 1, | \$ 26,500.00 | Dec. 31, \$ | 44,000.00 |
| " " payable " " | 7,500.00 | " " | 9,750.00 |
| " merchandise " " | 8,500.00 | " " | 9,500.00 |
| " plant and machinery " " | 10,000.00 | " " | 10,000.00 |
| " furniture and fixtures " " | 700.00 | " " | 700.00 |

A summary of cashbook for the year shows as follows:

| | |
|-----------------------------|--------------|
| Received: | |
| Accounts receivable | \$ 30,000.00 |
| Capital paid in | 2,500.00 |
| Disbursed: | |
| Bank overdraft Jan. 1 | 3,700.00 |
| Accounts payable | 12,500.00 |
| General expense | 5,000.00 |
| Wages | 7,750.00 |
| Personal account | 1,500.00 |

Leaving a Bank Account of \$2,000.00, and Currency on hand \$50.00.

Provide 5% interest on capital, disregarding additions during the year and personal drafts, deducting 10% for plant and machinery depreciation, 5% for furniture and fixtures, and 5% for bad debt reserve.

SOLUTION

The condition January 1, was:

| | | |
|------------------------------|--------------|--------------|
| Accounts receivable | \$ 26,500.00 | |
| Merchandise | 8,500.00 | |
| Plant and machinery | 10,000.00 | |
| Furniture and fixtures | 700.00 | 45,700.00 |
| | | <hr/> |
| Accounts payable | 7,500.00 | |
| Bank overdraft | 3,700.00 | 11,200.00 |
| | | <hr/> |
| Net worth | | \$ 34,500.00 |

The condition December 31, was:

| | |
|---------------------------|--------------|
| Accounts receivable | \$ 44,000.00 |
| Merchandise | 9,500.00 |
| Plant and machinery | 10,000.00 |

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| | | |
|--|---------------------|----------------------------|
| Furniture and fixtures | 700.00 | |
| Cash on hand and in bank | 2,050.00 | |
| | <u>\$ 66,250.00</u> | |
| Accounts payable | 9,750.00 | 56,500.00 |
| Increase in net worth at the face of assets | | \$ 22,000.00 |
| Less depreciation plant and machinery | \$ 1,000.00 | |
| furniture and fixtures | 35.00 | |
| Reserve for bad debts | 2,200.00 | 3,235.00 |
| | | <u> </u> |
| Increase net worth revalued assets | | \$ 18,765.00 |
| Less excess contribution over withdrawal by proprietor | | 1,000.00 |
| | | <u> </u> |
| Profit of year by single entry method | | <u><u>\$ 17,765.00</u></u> |
| Of which \$1,725.00 is interest on capital. | | |

PROFIT AND LOSS, DOUBLE ENTRY STATEMENT

| | | |
|--|---------------------|----------------------------|
| Sales: Account receivable, Dec. 31. | \$ 44,000.00 | |
| " " Cash paid in | 30,000.00 | |
| | <u>\$ 74,000.00</u> | |
| Less accounts, Jany. 1 | 26,500.00 | |
| | <u> </u> | |
| Total sales | | \$ 47,500.00 |
| Merchandise, inventory Jan. 1 | \$ 8,500.00 | |
| Purchases, accounts: | | |
| Payable Dec. 31 | \$ 9,750.00 | |
| Cash paid | 12,500.00 | |
| | <u>\$22,250.00</u> | |
| Less accounts, Jan. 1 | 7,500.00 | 14,750.00 |
| | <u> </u> | |
| | | \$ 23,250.00 |
| Less inventory, Dec. 31 | 9,500.00 | |
| | <u> </u> | |
| Cost of goods sold | \$ 13,750.00 | |
| General expense | 5,000.00 | |
| Wages | 7,750.00 | |
| Depreciation plant and machinery | 1,000.00 | |
| furniture and fixtures | 35.00 | |
| Reserve for bad debts | 2,200.00 | 29,735.00 |
| | <u> </u> | |
| Net profit | | \$ 17,765.00 |
| Interest on capital | | 1,725.00 |
| | | <u> </u> |
| Net profit, above interest | | <u><u>\$ 16,040.00</u></u> |

The cash paid in by customers and the amount owed by them on December 31 would represent the total amount bought by them, if they had not owed anything at the beginning of the year. By deducting this latter amount the total sales of the year are found. In the same way the total purchases of the year are found. Adding these to the inventory of January 1, and deducting the inventory of December 31, gives the cost of the goods sold, and, if necessary, the gross profit on sales. The rest of the statement is self-explanatory.

Correspondence

Department Store Accounting

Editor, *The Journal of Accountancy*:

Sir: In reading the article entitled *The Accountant's relation to Inventory*—an extract from HENRY C. MAGEE's *Department Store Accounting*—I was surprised to notice therein two glaring errors of accounting principle.

On page 444 of *THE JOURNAL* for December the following extract appears in connection with the author's treatment of goods received into stock in the latter part of a fiscal period, such goods being required for a future season's trade:

Neither are the invoices charged to purchases—thus neither goods nor invoices are considered among the assets and liabilities of the business. This is proper if the goods are for the succeeding season.

It is a well-established principle of accountancy, in Canada at least, that all goods in stock or in storage, delivery of which has been accepted, must be included in assets and liabilities, for the reason that the acceptor is liable to the shipper even though the goods be destroyed by fire. The liabilities to creditors are increased by the invoice amount of such goods; consequently, a corresponding amount must be added to inventory. On page 449 of *THE JOURNAL*, Mr. MAGEE says:

The turnover is generally reckoned by dividing the average stock at cost into the total sale instead of purchases. As comparative profits and expenses are figured for reasons of convenience on the basis of sales, the turnover is also taken on that basis and the result is the same in either case, when brought down to gross profit.

Turnover of stock based on purchases or sales, divided by average inventory, is fundamentally wrong as a mathematical proposition, and no reason of convenience should excuse comparisons made on such bases.

Turnover of stock is ascertained by dividing the cost of goods sold by average inventory—that is to say: add together the inventory at the beginning and the purchases for the period. From this total subtract the inventory at the end of the period, and the result is cost of goods sold. Divide this by the average of the two inventories at the beginning and end of the period respectively.

We professional accountants cannot be too careful in making sure that any statements made or published by us are sound in principle.

It is with this fact in mind that I beg to draw Mr. MAGEE's attention to these points.

Yours truly,

A. E. MIDDLETON HOPE, C.A.

Montreal, Dec. 29, 1913.

Correspondence

Editor, The Journal of Accountancy:

Sir: Answering Mr. HOPE's criticism on the subject of goods received during the last part of the fiscal period I do not think Mr. HOPE expresses exactly what he means; but in my opinion there would be no violation of accounting principles whatever for the following reasons:

1. If the invoices are not shown amongst the liabilities nor the goods amongst the assets the effect on the profits would be the same as if both were included at face value—it will be recalled that the article provided that the goods would not be distributed (but held in the custody of the receiving room).

2. No accounting principle is violated, but rather, is conserved if the goods are worth the invoice cost, and as a rule they are worth more, being advance merchandise on which certain of the preliminary expenses have been paid, thus increasing the asset value without increasing the liability. We specially stated that the principle would not apply to past seasonable goods—furthermore each season should as far as practicable stand on its own basis to obtain the benefits of comparison of turn-overs, etc.

3. Insurance is usually figured on the average amount of stock carried—not only in inventory, *et seq.*, but goods invoiced on consignment, goods held in trust, goods sold but not delivered, etc., and for which the insured may be liable in case of loss; therefore inventory, as commonly understood, is not the only basis for merchandise insurance.

4. An auxiliary record of these goods and invoices is kept for application to the new period so that the items must balance out in order to clear the record. Special attention was called to "last minute items."

Turnovers, like expenses, are often figured on the basis of sales for the purpose of convenience, but that does not necessarily argue against correctness. Profit is always finally figured on the investment, although comparatively figured on the basis of sales. The selling price can be much better ascertained than the cost, and cost is never absolutely known until the business is settled up and cashed. We stated: "The result is the same in either case when brought down to gross profit on merchandise investment." Let us take an example:

Assuming an investment in merchandise,—that is an average stock for a fiscal period,—of \$25,000, with a total turnover (sales) of \$100,000, the times turned would be four, as figured average stock into sales. Say that the cost of the goods sold is \$75,000, the *actual* times turned would be three. However, taking the four times at 25% profit, the result is 100% gross profit on amount turned, (which is the investment) namely, \$25,000, or \$25,000 profit. Then taking the three times turned at a profit of 33 $\frac{1}{3}$ % on the cost—(as goods costing \$75,000, sold for \$100,000, would be sold at the rate of 33 $\frac{1}{3}$ % profit on the cost), the result is 100% gross profit on the amount turned; also, \$25,000, making the profit likewise \$25,000, or reaching the same result by both methods.

It is not proper to figure turnover by taking "the average of the two inventories at the beginning and end of the period respectively," as stated by Mr. HOPE, because the inventory is frequently taken in the dull times

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when stocks are low, often much lower than the average, and it is the average stock which requires the financing and which costs the interest. Therefore in all up-to-date retail establishments the stock is estimated at frequent periods of the year, (sometimes as many as forty-eight times), and the average of all these stock estimates is taken as the average amount of money invested in merchandise—the inventory represents the investment in merchandise at inventory time only. While this might by a co-incidence be the same as the average for the entire period, it is most unlikely that it would be so.

Very truly yours,

HENRY C. MAGEE.

Philadelphia, Jan. 20, 1914.

Business Standing and Doings

Editor, The Journal of Accountancy:

Sir: I am enclosing a statement which from an accounting standpoint is unique to say the least. This is an actual copy of a statement submitted to us showing the activities of business which we examined about two years ago. In this connection a few words of explanation are in order:

Statement of business standing: By bills receivable in the statement is meant "open accounts receivable." "Checks not cashed" were post-dated checks; "inventory estimated" is an estimate of the equipment.

Statement of business doings: By the inventory of March 17, 1908, \$3,438.97, is meant the value of the equipment of the concern at said date:

These statements were prepared by a bookkeeper of this concern who had not had any instruction in accountancy, as I am informed, but who had studied out this method for himself. At the time we made the examination he was over 62 years. Our examination confirmed the fact that the result as shown by these statements was correct.

I thought this might possibly be of interest.

Yours very truly,

RALPH D. WEBB.

Minneapolis, Minn.

SCRAP IRON COMPANY

STATEMENT OF BUSINESS STANDING

| | | |
|---------------|----------------------------|-----------|
| Feb. 15, 1910 | Mdse. on hand | \$ 891.14 |
| " " " | Bills receivable | 1,832.20 |
| " " " | Cash in bank | 25,221.73 |
| " " " | Cks from A.G., not cashed | 2,168.03 |
| " " " | Notes on hand, not due ... | 5,886.71 |

Correspondence

| | | |
|---------------------------------|--------------------|-------------|
| " " " Inventory estimated | 2,500.00 | |
| Total | <u>\$38,499.81</u> | |
| Less Bills payable | 145.97 | \$38,353.84 |
| | <u>\$38,353.84</u> | |

Overdrafts by individual members:

| | | |
|-------|-----------------------|--------------------|
| M. R. | \$ 2,558.37 | |
| D. L. | 3,041.41 | |
| M. L. | 3,506.43 | |
| L. K. | <u>7,532.85</u> | <u>\$16,639.06</u> |
| | | \$54,992.90 |

Capital March 17, 1908:

| | | |
|------------------|------------------------|--------------------|
| M. R. | \$ 7,061.84 | |
| D. L. | 10,506.00 | |
| M. L. | 4,583.25 | |
| L. K. | <u>12,442.25</u> | <u>34,593.34</u> |
| Net Profit | | <u>\$20,399.56</u> |

Total Assets per share:

| | | |
|---------------------|-----------------|--------------------|
| M. R. Balance | \$ 4,593.47 | |
| Profit | <u>5,099.89</u> | \$ 9,693.36 |
| D. L. Balance | \$ 7,464.59 | |
| Profit | <u>5,099.89</u> | 12,564.43 |
| M. L. Balance | \$ 1,076.82 | |
| Profit | <u>5,099.89</u> | 6,176.71 |
| L. K. Balance | \$ 4,909.40 | |
| Profit | <u>5,099.89</u> | <u>10,009.29</u> |
| | | <u>\$38,353.84</u> |

STATEMENT OF BUSINESS DOINGS

February 15, 1910

| | | |
|--|-----------------|-------------------|
| From March 17, 1908 to Feb. 15, 1910. | | Total Mdse. |
| By " " " on hand | \$ 23,141.33 | |
| Mdse. bought during the period | 99,212.01 | \$122,353.34 |
| Mdse. sold during period, by ledger | \$168,928.66 | |
| Mdse. sold during period by cash | 1,204.55 | |
| Mdse. sold during period on hand Feb. 15, 1910 ... | 891.14 | |
| Inventory on March 17, 1908 | <u>3,438.97</u> | <u>174,463.32</u> |
| Gross Profit | | \$ 52,109.98 |

From which deduct:

| | |
|----------------------------------|--------------|
| Individual weekly drawings | \$ 13,860.00 |
|----------------------------------|--------------|

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| | | |
|---|----------|--------------|
| Salary | 2,475.00 | |
| Feed | 918.69 | |
| Repairs | 646.47 | |
| Rent | 886.20 | |
| Telephones | 518.20 | |
| Light & Power | 517.54 | |
| Medical treatment (injured employees) | 418.80 | |
| Stationery | 127.35 | |
| Interest | 289.45 | |
| Miscellaneous expense | 2,247.62 | |
| Labor | 8,805.10 | 31,710.42 |
| Net Profit | | \$ 20,399.56 |

Profit per share: M. R. \$5,099.89; D. L. \$5,099.89; M. L. \$5,099.89; L. K. \$5,099.89.

As to Professionals

The Editor, The Journal of Accountancy:

Will some one please rise and explain some of the difficulties created for the would-be independent practitioner by the standards of professional ethics proposed by ultra-professional professionals?

In the first place what is a profession? It cannot embrace all occupations characterized by brain work and the absence of manual labor, else executives in merchandising and manufacturing would be regarded as professional men, to say nothing of the gentry who live by their nimble wits.

Is a profession a calling which in the evolution of social custom has come to be practiced by educated men who have first pursued a course of study in that body of organized, systematized knowledge which pertains to the subject in which they profess to be skilled and constitutes its science? If so, the learned professions may no longer be three only—theology, law, medicine. How about engineering and accountancy?

But isn't the poor word "profession" overworked? Isn't a profession just a calling or vocation behaloeed and sanctified in its primeval days by people who wished to constitute themselves an aristocracy thereby? Has a comprehensive, unvague definition of the word ever been formulated?

But a more practical question is, How is our would-be practitioner to get—no, not business—a clientage? The February JOURNAL is emphatic, editorially, in the statement that "solicitation of any kind should not be countenanced." But without solicitation how can a man acquire a practice?

To be sure he may solicit immodestly, but may he not also present modestly his preparation and qualifications for a needed business service? May he not even solicit in such manner that he will not lose or jeopardize one whit of the personal confidence that is spoken of as the basis of the professional relation? And if he may solicit in person with propriety, why not by means of letters or announcement cards sent through the mails?

Correspondence

What is the alternative? Shall he repress his spirit of enterprise, bank the precious fires of youth, and give over his conviction that it is his privilege to play a large and useful part in our world? Shall he stifle the spirit of adventure which lures him to the discovery of the need that his mind and soul can supply? Shall he violate the law of service by refusing to seek his opportunity for service? Shall he sit in his office twirling his thumbs, waiting, Micawber-like, for something to turn up? Does nature love an economic vacuum in the early years of a professional man's life?

Come, brethren, come out upon these white pages—behind the mask of a *nom de plume* if you must—and tell our imaginary entrant, who will no longer accept your salary because of the larger faith that is in him, how to remain dumb and yet acquire a practice! Like good sportsmen let us applaud his fine spirit, but let us also justify to him our creed that to rise to the high heights of professional ethics he must willingly suffer paralysis of enterprise, strangulation of initiative, and ultimate financial dissolution.

To this practical question our hypothetical candidate *solicits* a practical answer.

Yours very truly,

A. W. WEIGHT.

New York, Feb. 27.

New York C. P. A. Examinations

Solutions of Question 5

Editor, The Journal of Accountancy:

Sir: I herewith forward a solution of question 5, part 2, practical accountancy, 35th New York C. P. A. examinations, which is offered in review of that submitted in the November issue of THE JOURNAL OF ACCOUNTANCY.

Truly yours,

FRANK BREWSTER, C. P. A.

Cleveland, O., Jan. 22

J of A Sept, 1913, pp. 248-9

June 25, 1913

Q 5 Practical Accounting Part II

GIVEN

| | |
|---|-----------------|
| Value of the alleged inventory Jan'y 1, 1912 in the Paterson store | \$3,800.00 |
| Purchases for both stores Jan'y to July paid for | \$5,128.80 |
| Due to creditors on acct. of both stores July 1 | 1,500.00 |
| | <u>6,628.80</u> |
| Cash sales Newark store | 1,875.00 |
| Cash sales Paterson store | 3,105.00 |
| Profits 50% of sales | |
| Purchases Paterson store January to July | 3,325.00 |
| Value of Stores July 1, 1912: | |
| Paterson | 4,573.50 |
| Newark | 3,600.00 |

ASKED

A statement proving whether or not the inventory of the Paterson store January 1, 1912 was correct as stated

SOLUTION

Paterson Store

| | |
|---|-----------------|
| Alleged inventory January 1, 1912 | \$3,800.00 |
| Add purchases January to July 1912 .. | 3,325.00 |
| Total merchandise to account for .. | 7,125.00 |
| | <u>7,125.00</u> |
| Deduct cost of merchandise sales \$3,105.00 at profit of 50% | 1,552.50 |
| | <u>5,572.50</u> |
| Value of merchandise which should be on hand July 1, 1912 | 5,572.50 |
| Given value of same | 4,573.50 |
| | <u>999.00</u> |
| Merchandise deficit July 1, 1912 | |
| Which indicates incorrect inventory Jan'y 1, 1912. | |

New York C. P. A. Examinations

REMARKS

The question evidences that A & B are owners of both stores, purchasing for and charging each store with the merchandise delivered to it, and crediting each store with the cash received from sales of merchandise.

A & B are therefore responsible for all liabilities incurred by the purchase of merchandise for the stores and not the stores.

Whether A & B are equal partners or not is not a part of the question.

It does not necessarily follow that the inventory of Jan. 1, 1912 was overstated because a deficit in merchandise is shown July 1, 1912. There are several ways in which a deficit could be created.

The solution of question 5, part 2, practical accounting, 35th New York C. P. A. examination, as submitted for publication by Paul L. Loenwarter, by some mischance failed to secure position in the January issue of THE JOURNAL OF ACCOUNTANCY. It is as follows:

SOLUTION

| | Paterson | Newark |
|--|-------------------|-------------------|
| 1912 July 1. Inventory as stated... | \$4,573.50 | \$3,600.00 |
| Cash sales Jan. 1 to June 30..... | \$3,105.00 | \$1,875.00 |
| Less 50% profit on sales..... | 1,552.50 | 937.50 |
| <i>Add sales at cost.....</i> | <i>1,552.50</i> | <i>937.50</i> |
| | \$6,126.00 | \$4,537.50 |
| <i>Purchases of period for both stores</i> | | |
| Jan. to June 30... | | |
| Paid for..... | \$5,128.80 | |
| Not paid for to June 30..... | 1,500.00 | |
| <i>Total purchases of period.....</i> | <i>\$6,628.80</i> | |
| <i>Purchases, Paterson store.....</i> | <i>3,325.00</i> | |
| | 3,325.00 | |
| <i>Balance of purchases for Newark store</i> | <i>\$3,303.80</i> | <i>3,303.80</i> |
| <i>Inventory Jan. 1, 1912 should have been</i> | <i>\$2,801.00</i> | <i>\$1,233.70</i> |
| <i>Alleged inventory Paterson store</i> | | |
| Jan. 1, 1912..... | 3,800.00 | |
| <i>Paterson inventory Jan. 1, 1912 being over totaled.....</i> | <i>\$ 999.00</i> | |
| <i>Proof</i> | | |
| <i>Inventory Jan. 1, 1912. Paterson...</i> | <i>\$2,801.00</i> | |
| <i>Newark....</i> | <i>1,233.70</i> | |
| | | 4,034.70 |
| <i>Purchases paid for.....</i> | <i>5,128.80</i> | |
| <i>Purchases not paid for.....</i> | <i>1,500.00</i> | |
| | | 6,628.80 |
| | | \$10,663.50 |

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| | | | |
|--|------------|------------|-------------|
| <i>Sales</i> Paterson..... | \$3,105.00 | | |
| Newark..... | 1,875.00 | | |
| | | | |
| | \$4,980.00 | | |
| <i>Less 50% Profit</i> | 2,490.00 | | |
| <i>Consumption of period</i> | | | |
| | | | 2,490.00 |
| <i>Stock to be accounted for</i> | | | \$ 8,173.50 |
| | | | |
| <i>Inventories July 1, 1912</i> | Paterson | 4,573.50 | |
| | Newark.. | 3,600.00 | |
| | | | |
| | | \$8,173.50 | |

REMARKS

The question at issue, while it speaks of the value of the two sides, at Paterson and Newark respectively, in the writer's estimation could not mean to aim at the net worth of the firm at the dates mentioned in the problem. This viewpoint seems to have been taken by your correspondent from Dallas to judge from the wording of his solution.

By assuming this to be so, he concluded to divide the amount of \$1,500 due to creditors into two even parts in spite of the problem stating: "Purchases, Paterson store, January to July \$3,325."

This in the writer's opinion seems to imply that all other purchases, whether paid or unpaid, should be charged to the Newark store.

Very truly yours,

PAUL L. LOWENWARTER.

Announcements

Society of Certified Public Accountants of the State of New Jersey

At a meeting of the Society of Certified Public Accountants of the State of New Jersey the following officers were elected for 1914: President, John B. Niven; vice-president, Ira C. Nichols; secretary, Frank G. Du Bois; treasurer, Edwin G. Woodling; trustees, W. Sanders Davies, Clarkson E. Lord, James M. Lewis, and Herbert S. Greenwood.

Maine Board of Accountancy

At the examination of applicants as certified public accountants, held at Augusta, Me., on January 27, 28 and 29, Messrs Joseph Emmett Hertz, of Portland, Me.; Charles Lewis Talbot, of Dorchester Center, Mass., and Willis H. Mitchell, of Washington, D. C., successfully passed the examination and received their certificates.

The death is announced of Peter Ballingall, C. P. A., president of the United States Audit Company, 107 Drexel building, Philadelphia. Mr. Ballingall was a resident of Cynwyd, Pa.

At a special meeting of the Institute of Chartered Accountants of Manitoba, J. Porter Joplin, C. P. A., of Chicago, was elected an honorary member of the Institute.

Fred. Haberstroh, C. P. A., announces his change of address from 43 Exchange Place to 53 Park Row, New York City.

Messrs. Perine & Nichols, 149 Broadway, New York City, announce that Mr. Charles W. Perry, C. P. A. retired January 31 from the service of the Audit Company of New York to become chief accountant for their firm.

Hollis H. Sawyer & Co., certified public accountants, announce the removal of their office from 60 Congress Street to 79 Milk Street, Boston, Mass.

Book Department

PRINCIPLES OF BOOKKEEPING AND FARM ACCOUNTS, by J. A. BEXELL and F. G. NICHOLS, pp. 176. *American Book Company*, 1913.

Principles of Bookkeeping and Farm Accounts is of so elementary a character that it can scarcely be of interest to accountants. Indeed the work was not intended for them, but rather for text-book use in farm bookkeeping. Many subjects are enumerated as contained in the text, but for the most part statements are made and procedure outlined without a full discussion of underlying principles.

The first twenty-six pages are given over to illustrations of the use of cash books for recording the receipts and disbursements of (a) private personal accounts, (b) household accounts and (c) poultry accounts. These terms are rather misleading in that the accounts are not really discussed, but only items typical of each group are given to record in a cash book following a model given in the text.

Six pages are devoted to the principles of double entry bookkeeping. The following unusual explanation of double-entry is found on page 37: "You have now noticed that every entry in the journal is found under the corresponding account in the ledger; that the sum of the journal entries equals the sum of the ledger entries, and that the two sides are equal. Hence the term, double-entry." Proper explanation of the term was given on the four preceding pages. The subjects of banking, business letters, business forms, live stock accounts, produce accounts, inventories, farm plots, financial statements, accounts receivable (the text states on page 108 "It is wholly unnecessary to keep accounts with creditors"), and valuation and depreciation are briefly stated and discussed, and in some cases problems or sets are used for illustration. Other problems and short sets are intended to give the student practice in the application of the principles advocated.

F. H. ELWELL, C.P. A.

The Journal of Accountancy

Official Organ of the American
Association of Public Accountants

Vol. 17

APRIL, 1914

No. 4

Fair Return to Public Utilities

BY JOHN B. GEIJSBEEK, C. P. A.

It is the intention to assert and explain in detail in this article the opinion that there is a time when a utility plant maintains a normal value beyond which the element of unknown wear and tear, commonly called depreciation, does not go. The position has been taken that theoretically this normal value lies midway between original cost value and scrap value in a normal plant. This statement is made in order to show that after the rate payers have refunded to the stockholders, in addition to the cost of actual repairs and renewals, the difference between the cost price and the normal value, thereafter the rate-payers cannot be compelled to pay to the stockholders anything further on account of depreciation. Inasmuch as this statement is probably something not commonly known it is necessary to fully explain this viewpoint. This premise has been advanced on several occasions, but it was fully described in a leaflet published about a year ago by James G. Allison, commissioner and chief engineer of the St. Louis Public Service commission.

The three charts which accompany this article give in detail the "value lines" of certain portions of equipment of a public service plant. By the first chart it is shown that if a plant consists of two elements only—here represented by the thin lines A and B—the heavy line between them comprises "the composite-value line," or the combined value line of these two elements of plant. The life of A is estimated to be ten years, and the life of B to be fifteen years. The dotted lines represent renewals of these elements of plant at the time of their total exhaustion.

It will be seen that the composite-value line meets the end of the renewals of A and B at the thirty-year period, and that at this time the percentage remaining of the original cost of the plant is zero. Therefore, with these two elements of plant alone, the plant must be entirely reconstructed every thirty years.

In the second chart the same premises have been assumed as those given in chart No. 1, with this addition, that it has been assumed that at the end of the fifth year of the existence of the plant a plant addition was made equal and similar to the first element of plant here named A, and that at the end of ten years it has been assumed an addition was made to the plant equal to the second part of the plant, called B. Both additions, here called *aa* and *bb*, have necessarily the same average life as the original elements of plant called A and B. The heavy line in this chart also represents the composite-value line, or in other words the combined values of the four elements of plant. It will be noted from the heavy line—or the composite-value line—that for fifty years it never reached the zero line, but that at the thirty-year period it reached the same value as at the end of the fifteen-year period, namely, 29.16% of the original cost, and that this same value was reached again at the end of another fifteen years, or forty-five years, and that this condition will continue to repeat itself forever. The deduction to be made from this chart is that if a plant is composed of elements which are continually renewed, and to which continual new additions due to natural growth of business are added, then the composite-value line can never reach a value that would mean complete depreciation or scrap value, in this instance zero.

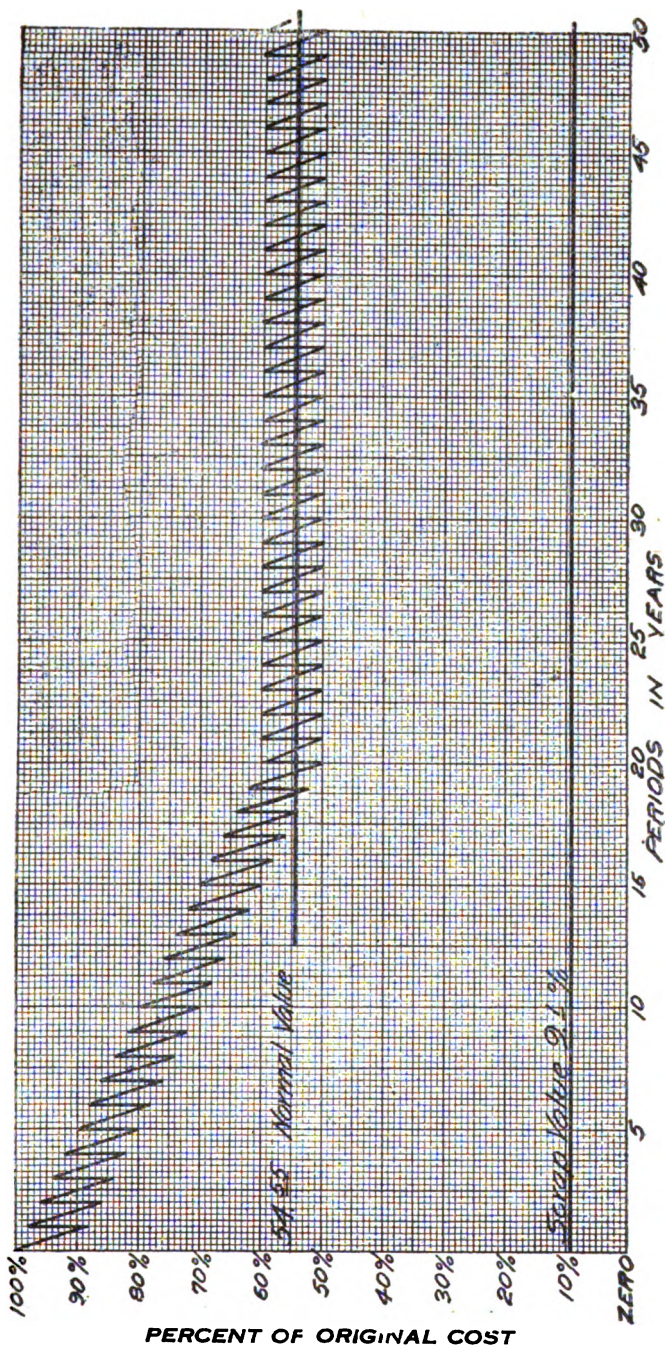
The third chart illustrates a composite-value line of a plant with a large number of continuous annual replacements and renewals, and in addition thereto betterments and additions from time to time. This chart is a continuation of chart No. 2 but introducing more elements of plant; hence more renewals, and also more additions, in order to bring it in keeping with the facts and conditions of the management of the business of a growing public utility.

It has been assumed in this chart that the scrap value was 9.1% of the original cost, and it will be seen from this that, as in chart No. 2, the composite-value line can never reach zero. On account of the large number of renewals, additions and better-

CHART NO. III

Third Illustration on "Normal Value" Line

This illustrates what will happen, theoretically, if renewals and additions as shown in the second illustration occur frequently and from year to year. Variations from normal value are slight under these conditions. The values can never reach zero or scrap value or complete depreciation. The annual variation from normal value is calculated by dividing the difference between scrap and cost values by the number representing the various lengths of life of the various units of the plant.



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Chart No. 2 assumes the same premises as explained for chart No. 1. The life of A is 10 years and the life of B is 15 years. At the end of five years an addition is made to the plant similar to A. The line representing this addition to plant is called *aa*. It is necessary therefore, at the end of the five years, to arrive at the composite value of A and B. A has a value of 50%; B has a value of $66\frac{2}{3}\%$; a total of $116\frac{2}{3}\%$, one-half of which is $58\frac{1}{3}\%$, or the composite value of A and B at the end of the fifth year. *aa* is then added to the plant and it becomes necessary to place this addition in the composite value line:

| | |
|---|--------------------|
| A as above is | 50% |
| B as above is | $66\frac{2}{3}\%$ |
| <i>aa</i> at cost | 100% |
| Total | $216\frac{2}{3}\%$ |
| One-third of which is the composite value, or | $72\frac{2}{9}\%$ |

It will be noticed that this time there has been taken one-third of the total percentage, because there are now three elements of the plant, and therefore the divisor becomes three instead of two. At the end of the 10-year period the renewal of A becomes necessary, and consideration of such renewal in the composite value must be ascertained:

| | |
|--|-------------------|
| A has a remaining value of | 000% |
| B has a remaining value of | $33\frac{1}{3}\%$ |
| <i>aa</i> has a remaining value of | 50% |
| Total | $83\frac{1}{3}\%$ |
| One-third of which, or the composite value, is | $27\frac{7}{9}\%$ |

Then occurs the renewal of A, but in addition to the renewal of A there is added to the plant another unit similar to B, the line representing this addition being called *bb*. After the renewal of A and the addition of *bb* the composite value is calculated as follows:

| | |
|---|--------------------|
| A as renewed is | 100% |
| B's remaining value, as above | $33\frac{1}{3}\%$ |
| <i>aa</i> , remaining value as above | 50% |
| <i>bb</i> , new addition at cost | 100% |
| Total | $283\frac{1}{3}\%$ |
| One-fourth, or the composite value, of which is | $70\frac{5}{6}\%$ |

As there are now four elements in the composite value the

Fair Return to Public Utilities

divisor has been changed from three to four. At the end of the 15-year period, B has to be renewed, and also *aa*, because *aa*'s life is 10 years and was installed in the plant in the fifth year, therefore it is exhausted in the fifteenth year. Before the renewal of B and *aa*, the composite value is as follows:

| | |
|--|----------|
| A, remaining value | 50% |
| <i>bb</i> , remaining value | 66-2/3% |
| Total | 116-2/3% |
| One-fourth, or the composite value of which is | 29-1/6% |

After the renewal of B and *aa* the composite value would be computed as follows:

| | |
|---|----------|
| A, remaining value as above | 50% |
| B, new value at cost | 100% |
| <i>aa</i> , new at cost | 100% |
| <i>bb</i> , remaining value as above | 62-2/3% |
| Total | 316-2/3% |
| One-fourth of which, or the composite value, is | 79-1/6% |

At the end of the 20-year period A must be renewed, and prior to its renewal the composite value is found as follows:

| | |
|---|---------|
| <i>aa</i> , remaining value | 50% |
| <i>bb</i> , remaining value | 33-1/3% |
| B, remaining value | 66-2/3% |
| Total | 150% |
| One-fourth of which, or the composite value, is | 37-1/2% |

After the renewal of A the composite value is computed as follows:

| | |
|---|---------|
| <i>aa</i> , remaining value as above | 50% |
| <i>bb</i> , remaining value as above | 33-1/3% |
| B, remaining value as above | 66-2/3% |
| A, new value at cost | 100% |
| Total | 250% |
| One-fourth of which, or the composite value, is | 62-1/2% |

At the end of the twenty-fifth year *aa* and *bb* are both valueless and have to be renewed. The composite value prior to renewal of these two is as follows:

| | |
|---|---------|
| B, remaining value | 33-1/3% |
| A, remaining value | 50% |
| Total | 83-1/3% |
| One-fourth of which, or the composite value, is | 20-5/6% |

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Taking the renewals of *bb* and *aa* the composite value is computed as follows:

| | |
|---|----------|
| B, remaining value as above | 33-1/3% |
| A, remaining value as above | 50% |
| <i>aa</i> new at cost | 100% |
| <i>bb</i> new at cost | 100% |
| Total | 283-1/3% |
| One-fourth of which, or the composite value, is | 70-5/6% |

At the end of the 30-year period A and B are valueless and the composite-value line prior to renewal is computed as follows:

| | |
|---|----------|
| <i>aa</i> , remaining value | 50% |
| <i>bb</i> , remaining value | 66-2/3% |
| Total | 116-2/3% |
| One-fourth of which, or the composite value, is | 29-1/6% |

After the renewal of A and B the composite value would be as follows:

| | |
|---|----------|
| <i>aa</i> , remaining value as above | 50% |
| <i>bb</i> , remaining value as above | 66-2/3% |
| A, new at cost | 100% |
| B, new at cost | 100% |
| Total | 316-2/3% |
| One-fourth of which, or the composite value, is | 79-1/6% |

It will be noticed from the chart that at the 15-year period the composite-value line before renewal was 29-1/6% and that this same percentage was obtained at the end of the 30-year period. Therefore, after the 30-year period, each 15-year composite-line will repeat itself, this because 15 years is the longest life of any of the elements of the plant. Therefore, this chart teaches among other things that the composite-value line will repeat itself at the end of the period representing the longest average life of any one element in the plant.

The chart further teaches that if there are introduced into a plant at stated periods new additions, such as are customary in the ordinary business of any growing public utility plant, then the composite-value line of the entire plant can never reach the zero line, which represents total depreciation of all the plant. It also teaches that if there are introduced into the chart more original elements of plant, and more additions, and more renewals,

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then the variation between the lowest composite value before renewals and the highest composite value after renewals and additions have been introduced will become less in percentage of original elements of plant, and more additions and more renewals, in chart No. 3.

The annual variation between value before renewal and after renewal, from the normal or average line, is calculated by dividing the difference between scrap value and cost value by the number representing the various lengths of life of the various elements of the plant. After the period of construction renewals and additions follow so closely that a plant retains a normal value. Thereafter the repairs and renewals line will keep that value at a normal figure, obviating the necessity of providing for further depreciation.

The Three Elements of Plant Deterioration: Repairs, Renewals, Depreciation.

Depreciation, as such, is always a moot question among courts, economists, engineers, accountants and managers of concerns to which the doctrine of depreciation is to be applied. The normal value theories as herein set forth will be illustrated as they would obtain in a plant in which the doctrine of depreciation is difficult to apply—namely, a telephone plant. In regard to depreciation of telephone plants the additional difficulty is encountered in that but few economists, engineers, accountants and courts have had opportunity to study the question, or therefore to follow precedent in this instance.

The difference between depreciation of a telephone plant and that of any other plant is that the former embraces a large number of small integral but expensive pieces of manufactured articles as contrasted with the heavy bulky units of railroads, tramways, water and other similar large plants; and furthermore, the equipment of a telephone plant is exceedingly delicate, intricate and expensive. It is an established principle that heavy bulky articles do not depreciate as completely as do small manufactured articles. Therefore, taking a telephone plant by pieces, there is found an enormous number of small articles the value of which may be said to disappear almost completely. Yet, taking all these pieces as a whole the completeness of the deterioration of value does not exist to that same extent because the plant is so intri-

cate and delicate that charges for maintenance and repairs must be high to keep it to a very high standard; otherwise it could not be operated.

The efficiency as to the maintenance of a telephone plant, as far as can be found, has no equal in any of the other plants to which the principle of depreciation has been applied by courts, economists, engineers and accountants. To illustrate this, the following might be stated: A tramway system may have cars which almost fall to pieces, or rails that are almost worn out, and a road bed that cannot be considered as having a solid foundation—yet every passenger is willing and is almost compelled to use the tramway car to its full extent and pay the same price as if it were a good, new, up-to-date system. The result is that, with equipment in bad repair, the revenue may be at its height.

In considering a telephone plant it should be remembered that, if its efficiency of operating is low the inevitable and immediate result is that, through the operating inefficiency or defects in the mechanism, the telephone in most instances is put out of service. With a telephone system, the mechanical efficiency of which is poor, the revenue will naturally be reduced by that condition. An inefficient telephone system is expensive to the user at any cost, its value lying in its efficiency and extent. From this it may be deduced that a telephone system must be in the highest possible state of perfection. The only way to keep this up to a high percentage of operating efficiency is through the medium of large cost of direct maintenance. Further, this becomes the more important owing to the fact that it comprises such a large number of small manufactured articles. This high direct maintenance cost does not exist in plants composed of comparatively few but large units. Here repairs remain, as a rule, at a minimum, and at different periods, or stated intervals, what is left of certain sections and portions of equipment is discarded and entirely new and up-to-date equipment is installed. From the latter method one may see that it is easy to distinguish and differentiate between maintenance, repairs, and renewals on the one hand and depreciation, or whatever one may call it, on the other hand. The point to be brought out is that by virtue of the high efficiency to be maintained in a telephone plant—the maintenance, renewal and depreciation—are so closely

allied and interwoven that it is difficult to segregate them, and therefore it is more difficult for experts to determine the amount of depreciation on such a peculiar plant.

There is an important element in the factor of depreciation that must be considered, and that is the average life of the entire plant. It is customary to consider that a plant has a certain average life. The total plant value is divided by the average number of years of life of the plant. Thus the annual depreciation is obtained subject to the element of residual value. This process is faulty, for the reason that no plant can at any time in its entirety become absolutely valueless. This statement does not refer alone to the fact that every plant has a certain scrap value which in proportion to the entire value is small. It is intended to show that if the plant of a going concern is in operation it must have a certain value at all times considerably higher than scrap value, because if it were in a poor condition as far as operating efficiency is concerned it could not be operated. It must, therefore, be in a condition where it must have far more value than is scrap, if the plant remains a going concern. What percentage of total cost of the plant thus remains as a live factor, as long as the owners are operating the property is a disputed question; but some economists and engineers as well have held that for a traction company or an electric car system this is at least 50%.

Considering the previous statements in regard to the fact that operating efficiency of a traction company can be far lower than that of a delicate and intricate telephone system, the value of a going concern in the telephone business with high efficiency must be considerably more than 50% of its original cost; in fact it is above 80%. These statements are not made in relation to the value to be paid for the plant in case of a sale or the market value, but rather to a value that represents the investment upon which a fair return should be earned. If depreciation is charged in addition to repairs and renewals the public, or the consumer, has paid back to the utility company that amount for immediately existing reduction in the value of the property due to wear and tear not yet made good by renewals. That is either in the pockets of investors or stockholders or is in a reserve fund; if not in the fund, then it is in the reserve account and has been used to purchase additional plant. Thus the depreciated plant value,

added to earned surplus either on hand or paid to stockholders, will equal the original investment. In such a case a fair return can be only on the depreciated value of the original cash investment and not on the cost of reproduction. Therefore, if depreciation is allowed in addition to repairs and replacements, the cash investment upon which a fair return is allowed is reduced each year by the amount of depreciation so allowed. Hence the rate should be reduced each year by the interest or the fair return on the depreciation allowed. Thus continued for as long as depreciation continues—or 50% of the cost, or the life of the plant—a fair return on the first half of the capital must cease at the same time that the depreciation ceases. The utility corporation cannot have both—namely, the return on the principal in depreciation and interest on the amount so repaid by the consumer.

The normal value of a large plant cannot fall below 50% of the difference between cost and scrap value, because the average life of a large number of units, each of a different length of life, gives such a variety of lengths of life, especially if installed at numerous different periods, so that the time of complete uselessness of the individual parts of the plant falls at so many different periods that the renewal of these parts at their various periods makes it impossible for the entire plant to ever reach the period of complete scrap value, either through obsolescence or wear and tear. Therefore, while at any given period an uncomputable depreciation undoubtedly exists it will never become evident in the plant that constantly becomes a subject of renewals, repairs and replacements on account of obsolescence. The oftener parts of the plant become obsolete the higher the maintenance and replacements will be, and the more impossible it becomes to find a time when the plant has only scrap value. The more intricate and delicate the plant, and the higher the demands for efficiency, the higher its maintenance and replacement must be and the farther off the inevitable period of complete uselessness. With it all the period of realization of the inevitable moment of that unknown, uncomputable factor of ultimate plant deterioration is so far pushed into the future that no one can compute it. At any rate, the normal value lies nearer to the original cost than 50% of the difference between original cost and scrap value, as far as a well equipped public utility plant is concerned.

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Conclusions as to Deterioration.

Summing up what has been said about depreciation in the preceding pages: The deterioration of a plant consists of three elements: (1) Maintenance and repairs; (2) Renewals; (3) Depreciation. Of these three maintenance is a just current operating charge. Renewals are of such a nature as will reduce depreciation—the latter being that unknown, uncomputable factor of ultimate plant deterioration which exists at any period at which it is desired to ascertain exact plant values, because the renewal periods of parts of the plant have not as yet been experienced, nor are they due at this time. Therefore, if renewals run high, depreciation becomes very small, and in such a utility as a telephone company it becomes practically a negligible quantity, after having reached the “normal value,” which may be estimated at above 80% of the original cost.

The theory of “normal value” explained the reason why a plant cannot have depreciation below one-half of the difference between original cost and scrap value. It has also been shown that this element of depreciation is altogether separate and distinct from the actual outlays which the company must make and pay for from day to day for repairs and renewals. The amount to be paid by the rate payers for depreciation, therefore, is an item of compensation not to be paid out by the company for repairs and renewals, but to be paid out by the company as a refund to the stockholders for inevitable unknown wear and tear and as a just reimbursement for the loss in investment, which is the difference between original cost and normal value. Or, instead of paying this depreciation item to its stockholders in dividends out of surplus, this amount may be held by the company in a reserve account, or sometimes, a reserve fund, in order to keep the investment always at 100%, *i. e.*, present value (or ultimately normal value) plus unconsumed depreciation reserve must always equal original cost. How much this amount should be per annum, to be added to the rate, depends on the period of time in which the plant deteriorates to normal value. The annual amount, therefore is an item that can be fixed only arbitrarily, based upon theories as to what the average life of the elements of plant is; but this certainty exists, however, that the annual payments for depreciation should cease at the time the ratepayers have refunded in the rate a sufficient amount to

bring the investment from original cost down to normal value. After that period the rate payer need not pay anything beyond actual repairs and renewals.

It has been stated that it is difficult to separate repairs, renewals and depreciation. While it is easy to make an arbitrary ruling whereby repairs can be separated from renewals it is difficult to draw the line between renewals and depreciation. This for the reason that renewals occur at different and uncertain periods not equal distances of time apart, nor equal in amount. For this reason renewals and depreciation can be calculated and estimated only as a combined factor. The "cost new" and the "present" values can be computed, but to divide the difference between these in the following component parts is too difficult for practical use. These component parts are:

- (1) The accrued but not experienced renewals;
- (2) That unknown portion of plant value lying between "cost new" and "normal" values.

The first is called "accrued renewals" because it is known that these will come some day, but they have not yet been experienced, due to that part of the average life of the plant unit that still remains intact and gives satisfactory service. The second is called "depreciation," and is that unknown portion of plant value lying between reproduction and normal values that will never be replaced by renewals and which should remain in the reserve accounts or funds to be given to the stockholder at the cessation of operations in order to return to him the 100% he has originally invested. In these calculations, therefore, the two elements of plant deterioration just described, ("depreciation and accrued renewals"), together with the "experienced renewals" should be combined in the rate for depreciation ascertained by actual valuation by an engineer.

Reserve for renewals is a method of bookkeeping whereby a certain amount is set aside at short intervals for the purpose of providing for renewals, instead of at irregular intervals and at times when these really occur. These renewals are caused by past use, and therefore, such an expenditure should not be chargeable to the future users of the public utility in question, because the cost for such wear and tear has been due to the users in the past and should be borne by them. Any addition to the present rate to cover renewals caused by use in the past

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would be exceedingly unfair. In other words, if the present rate does not provide for a portion of this renewal some time in the future, the then users will have to stand a large and sudden increase in the rate in order to cover this deterioration of equipment. This is unjust. If it is then decided that each present user of the public utility shall be charged with a portion of these renewals by an addition to the annual rate it must be decided how much such charge shall be. This can be done only by dividing or discriminating between repairs and renewals. If they were not divided it would not be possible to decide how much should be added each year to the rate in order to provide for this deterioration, which is bound to occur. The fact that such division cannot be made accurately and that it must be done arbitrarily does not take away the principle, and under these circumstances a just division is the best that can be done.

The three elements in maintaining the plant of a utility company at an efficient standard are repairs and maintenance, experienced renewals and depreciation to normal value. These three elements of cost of necessity have to be included in a rate. Inasmuch as the rate should be as uniform as possible without severe fluctuations, renewals should be provided for by a level annual return from the rate regardless of whether they are made during the year of collection, or not. Depreciation should also be provided for by a level annual rate.

If the exposition of the normal value principle is carried to its logical conclusion, it will be seen that the amount needed for the annual depreciation will diminish as the amount needed for renewals increases.

The proper reserves created upon the books of the corporation for these two factors of plant deterioration and the proper charge against the reserves for experiences renewals, will properly represent in these reserve accounts or funds the actual depreciation experienced.

The investment of the funds collected from the rate by the utility company in its own plant, or the investment in outside securities, is a matter of little moment in the consideration, with this exception—that the annual charge for reserve for renewals and depreciation should not be computed upon the straight line principle of depreciation, but upon the annuity plan, thereby reducing the annual charge included in the rate to that sum

which, accumulated at a fair rate of interest, will provide for the renewal; and depreciation requirements of the plant.

Fair Return on Investment.

Having decided the subject of depreciation the question of fair return on the investment comes up. It seems almost impossible to find any two men who agree on what amount the interest—considered to be the fair return—should be charged. Especially is there a great difference of opinion as to whether the fair return should be calculated on the original cost value or the cost to reproduce the property, or whether it shall be the depreciated value, or the present value, which ultimately will become the normal value. In case the depreciated or present value is taken, a difficult element enters—namely, the fact that the stock issued and outstanding for the original investment still remains intact and that, because the corporation has conducted its business well and faithfully and has not looted the profits by declaring large dividends, there is a penalty upon the corporation and its stockholders when the rate payers commence to pay interest only on the reduced value, just because there happens to be an argument about the present value and because an inventory shows that the present value is lower than the original cost on the stock outstanding.

However, if the rate-payers, by a slight addition to the rates in the past, have paid an additional profit over and above a fair return on the stock outstanding, then the company must have accumulated a reserve or a surplus equal to this addition to the rate, and if this additional amount in surplus or reserve accounts—whether in cash or invested in the plant—is on hand and available to the stockholders, it may be declared as a stock dividend. It must be considered, however, that the reserve or surplus spoken of is not that necessary reserve for renewals and depreciation, but it is an additional sum over the calculated requirements for renewals and depreciation.

It is only necessary, therefore, that the fair return on investment be made on the present value of the plant, with an addition to the return to include interest on the reserves created for renewals and depreciation, if these reserves have been invested in the plant. This is necessary for the reason that the periodical charge for these reserves included in the rate is in

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a reduced ratio on account of the contemplated compound interest required in the annuity method, so it follows that the present value of the plant is the base upon which a fair return should be calculated—but to the present value must be added adequate interest upon the reserve for renewals and depreciation invested in plant. It follows that the reserve deducted from the cost new, or book values of the plant, will equal the outstanding present stock together with the surplus accumulated or the present value and ultimately normal value.

Governmental Profit and Loss

JOHN B. TANNER

A statement of governmental revenue and expenditure is not a statement of governmental profit and loss. The purpose of this article is to direct attention to the interpretation of a governmental revenue and expenditure statement and to evoke discussion of the elements of governmental profit and loss. A statement of governmental revenue and expenditure, although analogous in form to a like statement for a commercial enterprise, is far from being analogous in its exposition of the results of operations. Any attempt to interpret governmental revenue and expenditure as being profit and loss would be baffling. An interpretation of such nature would be misleading and erroneous. It should not be understood that revenue and expenditure statements have no place in governmental accounting. Any scheme of governmental accounting must comprehend every principle of the balance sheet and of the income account. These accounting principles are immutable both in commercial and governmental accounting, but governmental accounting must comprehend, in addition thereto, a new concept of profit, not analogous to principles found in commercial accounting.

Right thinking on the part of the public is the hope of democracy. Accountants, economists, statisticians and public officials are under responsible obligations to so direct and develop business and accounting methods in affairs of government as to make it possible for the public at large to thoroughly understand past accomplishments and to wisely determine the policies of future undertakings.

It is generally acceded that our republican form of government is, at least in theory, (and should be in practice), a government of, for, and by the people. Any unit of government, whether national, state or local, is a coöperative organization of citizens having a proprietary interest therein. In the last analysis, government has but one function. No matter how numerous the activities of government or in how great detail its purposes may be classified, the conclusion must be that all classifications are but refinements of the basic function—the advance-

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ment of social welfare. Activities which cannot logically be placed as refinements of this basic function should not be undertaken by the organism of government. It might be wise for the national government to take over the telephone, telegraph, and transportation facilities of the country, but in so doing it would be justified only on the theory that social conditions are made evil by bad economic conditions, and conversely, that improvement of these economic conditions makes for better social conditions. This theory might justify governmental interference; but, eliminate social consideration and the government would be interfering for the purpose of taking money from A to distribute to B, C, and D, which, *per se*, is indefensible.

The revenues of a governmental unit are derived either directly or indirectly through its corporate or sovereign power. There is usually no discernable relation between the source of revenue and the destination of expenditure. The revenues are largely a direct proprietary contribution to a communal fund to be expended for the benefit of all. To deny the truth of this statement is to deny the validity of our form of government. Although the payment of taxes is a voluntary contribution on the part of the majority and an involuntary contribution on the part of the minority, yet all payments must be considered proprietary contributions. These are not profit to the governmental organization any more than the investment of proprietary capital is profit to a business corporation.

Commercial accounting reflects the operations of a commercial enterprise in terms of profit and loss. Thus commercial accounting enables the owners of an enterprise to form concrete judgments as to the efficiency of the personnel, the form of organization and the soundness of business policies. The owners of commercial enterprises find in their accounts statements of the extent of their ownership as to both the beginning and the close of any particular period. They base judgment on the simple proposition that efficient personnel, efficient organization, and sound business policies result in increase in the extent of ownership; while inefficient personnel, inefficient organization, and unsound business policies result in a decrease of such proprietary interest.

A consideration of the function and activities of government makes it apparent that governmental accounting does *not* dis-

close efficiency or inefficiency in terms of profit or loss. As has been stated the revenues are derived through corporate or sovereign power, and expenditures are determined by the conceptions entertained by the public as to activities which should be carried on. The source of revenue and the purpose of expenditure cannot be combined in a financial statement so as to represent profit and loss. The assets of the government are not owned for the purpose of producing financial revenues, neither are its operations carried on nor are its losses sustained for the purpose of producing financial profit. Governmental organization is for profit, but not for commercial profit. In commercial accounting profit is the accretion to the fiscal condition of the enterprise. In governmental accounting profit is the advancement of social welfare.

It is evident that the results to be obtained from governmental accounting are not limited wholly to fiscal affairs. Governmental accounting can and should show the activities undertaken and the cost of each activity. Such cost is not a loss in the commercial sense. It is an expenditure of moneys received as proprietary contributions and it is therefore a direct diminution of proprietary interest. It seems evident that the expenditures to carry on a governmental activity is cost, cause or measure of effort. This being true, it is necessary to determine the effect or benefit arising from such expenditure. Since the purpose of the expenditure is the advancement of social welfare, and not the production of commercial profit, the results or benefits must be found in an analysis of the effect of the undertaking upon the status of social welfare.

It is apparent that the commercial rule for determining and interpreting profit and loss cannot be applied to governmental undertakings. Now, because the rule for determining commercial profit and loss cannot be applied, it does not follow that it is impossible to devise an adequate rule to be used by all governing bodies in recording and reporting the costs and results of communal effort. The writer has therefore evolved the following rule for the determination of governmental profit and loss:

The worth of any activity of government must be determined by *an appraisal of the value* of such service to the public good *compared with the cost* of such service.

This rule means that the value of any activity of government

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must be determined by an intelligent analysis of the results obtained. An intelligent analysis cannot be made from insufficient or misleading data. A statement of revenue and expenditure is entirely inadequate for the purpose of appraising the value of the benefits obtained. In fact a statement setting forth revenues and expenditures, unless specifically described, is misleading. The fact that it is misleading is, without doubt, largely due to the usual methods of presenting and interpreting commercial revenue and expenditure. Such statements should be avoided in setting forth governmental profit and loss.

Officials responsible for the promulgation of governmental reports should assiduously endeavor to make such reports in a simple and nontechnical manner so that the ordinary citizen may read and comprehend. The publishing of exhaustive financial reports and separate volumes of statistics and descriptive data is so violent a divorcement of the elements of cause and effect as to make it impossible for the public to form any reasonable conception of the success or failure of governmental activity. Furthermore there is little merit in reporting to citizens only in terms of millions of dollars. Few people can comprehend financial figures which transcend their daily experience. Recapitulations of revenue and expenditure are of course desirable, but the costs of government should be classified according to the units of organization and often according to the internal activities of a given unit.

This method of classification may perhaps be aptly illustrated by activities of the Industrial Commission of Wisconsin, as follows: General administration; safety and sanitation; free employment offices; woman and child labor; workmen's compensation; bakeries and confectionaries; arbitrations; boiler inspection; building code; old-age pensions; minimum wage; statistical department. The records of cost are so maintained as to show separately and in extended detail the actual cost of carrying on each activity. It would be manifestly impractical to ask the public to pass judgment upon the value of the entire service rendered by this commission by giving to it in one volume a report of the cost and in a separate volume statistics of results and an exhaustive description of the work accomplished. The value of the work of this commission can be determined only by an appraisal of the worth of each particular activity. The com-

mission will in future report to the public not only the detail cost of each particular activity but in conjunction therewith the statistics of results obtained. The cost of administering the workmen's compensation law and the results of such activity will under this plan become a report complete in itself. It will not be clouded by inclusion of fiscal or other statistical facts relative to other activities. The public will be able to comprehend the purpose of this activity, and the ordinary individual may arrive at a conclusion as to the value of the result obtained and as to whether it is or is not commensurate with the cost. Actual knowledge of fact will be the basis for making any change in the policy affecting this activity.

Some readers may believe that the plan proposed here is theoretical and abstract; that it is impossible to make an appraisal of a social service. However, it must be admitted that it is no more difficult to appraise social service than it is to appraise any other service of an intangible nature.

The business man who spends money for newspaper advertising certainly appraises the value of the benefit received therefrom. It is quite impossible to demonstrate that the value received from newspaper advertising is any more tangible than the benefit received through a municipal fire department. In both cases the valuation of the results must be made by a comparison of conditions as they existed at different dates or of conditions in similar enterprises. In the case of advertising it is possible to determine the efficiency of policies employed, and in the case of the fire department it is possible to determine the efficiency of policies, organization and business methods.

The business men of San Francisco have appraised the value of the Panama-Pacific exposition, and on the basis of that appraisal they as wise and experienced business men are spending large sums of money. They are far within the region of the abstract in valuing the benefit the exposition will be to that city and also to themselves as individual merchants. Every person who reads this article may have spent money for intangible things which could not be inventoried after the expenditure had been made. Such simple transactions as money spent for theatre tickets or tuition paid for schooling are expenditures for service, and the payment of money is proof of an appraisal on the part of the payor. In order that the plan herein suggested for determin-

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ing governmental profit and loss may not be misunderstood, it should be noted that the recommendation is for an appraisal of service, not for an appraisal of personal services. The appraisal of personal service is a matter of internal administrative efficiency and is not under discussion at this time.

The accountant and statistician will be quick to see that this plan of presenting information for public consumption is predicated upon the correlation of the work of the accountant and the statistician. The classification used by the statistician in compiling statistics must be exactly the same as the classification used by the accountant in grouping costs. The accountant is dealing with figures measuring effort. The statistician is dealing with figures measuring results. The accountant records values released, and the statistician records values received. It is these two elements that the candidate for office invariably uses in making a political campaign. Often it is the problem of the justification of expenditure, and the natural and logical method is to array facts regarding costs over against results attained.

It is believed that all government accountants must recognize this theory of governmental profit and loss and must include in the accounting machinery an automatic plan of procedure for the accumulation of statistics of result. The writer has advanced the belief that *right thinking on the part of the public is the hope of democracy*. Indeed it seems evident that right thinking cannot prevail until the people receive in proper form true reports of costs and results. Such reports should be made contemporaneously and as far as possible in juxtaposition. When such profit and loss reports are in general use no longer will ignorance exist through lack of proper information, and no longer will erroneous conclusions prevail. There is every reason to believe that such reports, making it easy to compare cost and results and making it possible to compare the efficiency of one unit of government with a similar unit, will have a far-reaching effect upon the administration of governmental affairs. Extravagance, inefficiency and unscientific organization will be brought to light.

The reader will comprehend that the plan here proposed is entirely in harmony with the mental process of the ordinary citizen. The use of this plan will not require any change in the mental attitude towards affairs of government. It will, however, be far reaching in its effect upon the present crude and

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unsuccessful methods of valuing the benefits of government. It is believed that it will bring about an enlarged conception of the function of government, the problem of social welfare and the principles which must be followed in the administration of communal undertakings. The reader is urged to consider the prevailing methods used by fiscal officers in reporting affairs of government and to note the prevailing failure of such reports to set forth in understandable form governmental profit and loss.

Problems in Municipal Indebtedness

BY HORACE SECRIST, PH.D.

Many of the problems in municipal debt relate to these facts and conditions:

(1) Borrowing for most cities and for other municipal corporations is a necessity resulting from the functions which they perform.

(2) Public credit is often employed when taxation would be more legitimate.

(3) Borrowing, although usually indulged in too extensively when not carefully regulated, when used with discretion becomes a ready and legitimate means of securing immediate use of funds.

(4) To borrow successfully implies constant recourse to money markets, and familiarity with the market conditions as well as a keen sense of the rights and interests of the borrowing public. Connected with these general considerations are most of the problems with which we have occasion to deal here.

Many minor political units and practically all cities have important functions of an administrative character as well as of a business nature which include receipt and expenditure of large amounts of public money. An adequate performance of these functions involves in most cases the use of borrowed funds. These are, ordinarily, supplied by the investing public acting through the medium of banks and trust companies. Local units, therefore, through their elected officers, bid with private firms and corporations for the command of available capital. One problem in public debt, therefore, is the equalization of the bargaining power between local officials, representing taxpayers, and financial interests; and also of guarding against any betrayal of the public and still protecting the interests of the creditor.

The methods of protecting these interests are dissimilar. Municipalities are interested in selling bonds or other evidences of indebtedness at the lowest possible interest rates, in making terms of the longest duration allowable in order to defer taxation, and in borrowing as much as possible to keep down the tax rate. Creditors are interested in paying the lowest possible price for

bonds, in securing high interest rates, in the legality of the issues, in the forms which the instruments take, in the time they are to run, in the security offered, and in their general negotiability, etc. The safeguarding of interests of both parties to these financial transactions involves both political and economic considerations. The political side is concerned in that the public is acting through elected officials, who, in most instances, hold office for limited tenure only and on condition that they act in sympathy with the demands of a political constituency. The rights of the public must be in a measure guaranteed through such officials. On the other hand the problems of debt contraction, debt manipulation and debt payment involve not only political but also important economic considerations. Both sides of these questions require attention.

It is often impossible for local officials to be efficient and at the same time to retain their offices. Unfortunately efficiency is too frequently sacrificed. We must recognize that incompetency at least is too often the rule among public officials, and particularly so among those whose duties are of a really constructive and sometimes of a technical nature. The every day routine, for instance, of tax matters, may be mastered in every detail, and yet the ability and the desire to successfully and economically float a series of bonds and to make proper provision for paying the same may be wholly lacking on the part of the official. The use of a sinking fund to pay current expenses sometimes proves too great a temptation to be withstood. An official, or an administration which has squandered public money and raised a tax rate inordinately, may often be displaced, but cases are almost unknown where officials have lost public confidence, or administrations have been changed because of excessive borrowing. Opposition is contrary to the interests of the taxpayer because the day of payment is generally so far in future that chances remain of his not having to pay, or at least of his being better able to pay. Spasmodic objection to borrowing may make itself felt here and there, but the majority of taxpayers are usually willing to allow borrowing to continue. Small popular votes on questions of debt approval or rejection are the rule. The discount of the future acts as a potent force in determining action. Human nature and the political control of municipalities seem to be in league with the abuse of credit—the former because of discount of the

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future, the latter because of necessity to please a constituency. Some regulation of the power to borrow money and to dispose of the same is absolutely necessary, and the question turns upon the nature of proper control.

Constitutional debt control amounts, on the one hand, to a prohibition against subsidizing private capital, and on the other hand to a limitation of debt to a certain percentage of the assessed value of property. There can be no percentage of debt to the assessed value of property, which is *a priori* correct. In some political jurisdictions a 5% limit operates as no restriction,* and yet the abuse of public credit is proportionately as great as for the units borrowing much more. In other cases a 5% limit operates as an obstacle to legitimate enterprise.† There can be no single percentage limit that applies with equal legitimacy to all political units or even to those similarly situated. The variations in the limits in the United States, which range from 2½ to 18 and in Canada‡ approach 20%, are conclusive evidence of this truth. Besides, to merely indicate a maximum to which all units may borrow is not to regulate the use of public credit.

It may be that there is a percentage of debt to assessed value of property which for cities and towns of a specified district tends to assume a certain level, but that this percentage should apply to all units alike is indefensible. The average ratio of debt to assessed value of property for the cities and town of Rhode Island, in 1907, was 5.16%, and for 1908, 5.38%. But the maximum percentage for 38 civil divisions in 1907 was 23.26%, for a city with a population of 1,274; while the minimum percentage for the same divisions in the same year was 0.12% for a city of approximately the same size. Like variations are found as to 1908.§ A comparison of the same nature for Massachusetts shows a maximum percentage ratio of 7.45% for a city with a population of 97,434; and a minimum percentage ratio of 2.47% for a city with a population of 69,272. Eighteen cities,

* For the period 1903-1909 inclusive there was no county in Wisconsin which had an outstanding debt, equal to 50% of the legal limit—5%—for counties. More than 71% of the average indebtedness of the 61 indebted counties of the state for this period was less than 15% of the legal limit, *i. e.* less than 15% of the 5% of the assessed value. These facts are taken from study of county indebtedness in Wisconsin which the author made for the Wisconsin Tax commission.

† The experience of Chicago is a case in point. *Vide*, the interpretation of the Mueller Law (Chap. xxiv, Hurd's *Revised Statutes*, 1906), May 18, 1903, in "Lobdell v. City of Chicago," 81 N. E., 354, 227 Ill., 218.

‡ Perry, J. Roy, "Public Debts in Canada," University of Toronto Studies, Vol. I, pp. 79-80.

§ "Report of Taxation Laws," Providence, R. I., 1910, pp. 149, 155.

or 55% of all in the state, showed a percentage of net debt to assessed value under 5% ; while 15 cities, or 45% of all, showed a percentage of net debt to assessed value of over 5%. Even a larger variation exists for the towns—11.04% to 0.00%.*

Both as a measure of the amount of debt which a city is financially able to bear, as well as a barometer of the needs for borrowed funds constitutional, limitations are objectionable. As a code of regulations in which the interests of both creditor and debtor are guaranteed they amount to nothing. The amount of funds which a city should borrow is a portion of the total contribution which the taxpayers are willing to make governed in each case by the uses to which such funds are applied. If a community is new large expenditures are necessary to effect improvements indispensable to city development. If the city in question is large, and growing rapidly, the tax rate cannot be adjusted so as to provide for large capital expenditure and resort must be had to borrowing. On the other hand, in older communities, and often in school districts, normal expenditures can and should be adjusted to the machinery of taxation. The necessity of borrowing depends in each case upon the activity of the community together with the position to which it has arrived in satisfying cardinal needs and the policy of extension which it has adopted. How much a municipality borrows is largely inconsequential provided there is need for borrowed funds, and in case the payment of debt within a reasonable time is assured.

Borrowing is a financial device, useful when employed with discretion, and it is seldom liable to great abuse when a rigid policy of liquidation is followed. It is not borrowing that is bad in itself ; it is the disposition to escape tax burden by borrowing which is objectionable. The chief difficulty, and the one to be corrected, is the weakness in the system of local government whereby officials are permitted and encouraged to borrow for purposes which should be supported by taxation, to borrow too much for legitimate purposes and to defer debt payment too far into the future. Rigid constitutional restrictions on the amount of debt will not correct these abuses. The only certain guarantee against their continuance is the adoption of a system of administrative control in which a competent state board or commission, whose sanction must be had for the use of borrowing,

* "Statistics of Municipal Finances," Boston, 1907, pp. 66, 192.

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for the duration and amount of money to be borrowed, plays the controlling part. Control of municipal debt is a necessary part of the control of local finance, and in many respects the most urgent part. The problems associated with it call for further consideration.

The chief problem in debt payment so far as the debtors are concerned is the equalization of tax burdens between the present and the future. Most commonly provision is made for debt payment by the accumulation of a sinking fund, *i. e.*, "a fund to which a fixed proportion of the loan can be carried * * * and either applied at once in the reduction of the debt or invested at interest until it can be so applied." * Many state constitutions provide for the accumulation of such funds † by requiring that there be levied direct annual taxes at the times the loans are made and periodically thereafter. The sinking fund *per se* in public finance and public conscience so little developed that bond- was so low and public conscience so little developed, that bondholders had to be given some assurance that the principal of their loans would be paid when due, but as a method of debt payment and as a temptation to unprincipled and ignorant city officials, not only does a sinking fund clog and complicate the finances of a municipality but it has absolutely no redeeming features. Originally required as a guarantee to the creditor, and later as complete protection to the debtor, it has now in far too many instances neither one of these functions because the "fund" degenerates into an "account." Taxes may be levied in good faith, but that the proceeds are kept intact and invested properly, that they are not used to pay current expenses, for instance, is never certain so long as accounts are inaccurately and unintelligently kept and no public reports are made of them. The inviolability of this fund is the taxpayers' only protection against double taxation.

The taxpaying personnel may not be the same at the time the fund is misspent as it is when resort to further taxation is

* Murray, Alexander. "Municipal Finance," etc., *The Accountant*, March 26, 1910, p. 445.

† Payment of debt by the sinking fund method is being replaced to some degree by the serial method. This movement is praiseworthy for it takes out of the hands of local officials the control of large sums of money with which complicated questions arise concerning investments and which furnish temptations for illegitimate usage. Of the 158 cities of the United States with population of over 30,000 in 1907, 135 reported some serial loans. "Statistics of Cities with Populations over 30,000" 1907, Washington, p. 73.

Of the growing use of the serial method of debt payment in Massachusetts, see "Third Annual Report of the Statistics of Municipal Finances," 1908-9, p. xxvi. Boston, 1911.

made necessary, but this does not change the effect of the misappropriation. The moneys have been set aside for a particular purpose, and their use for purposes not intended cannot fail to cloud not only the perspective of the public relative to the total tax levy also to open the way for an illegitimate use of public funds. Occasions may arise when certain savings would result from the application of sinking funds to new borrowing powers, especially when desirable investments are not at hand, when bonds outstanding are not due and cannot be readily purchased, etc. Most of these difficulties, however, may be avoided by the adoption of serial payment. At best such a procedure is questionable and is possessed of many of the objections as in the prevalent practice of some American cities that invest their bond issues in their own sinking funds, thereby creating a forced market for their securities.* "For a municipality to sell its bonds to the sinking fund is the same as borrowing from the sinking fund." † The local government board in England, in its "Provisional Orders," specifically inserts the following clause when dealing with securities in which public sinking funds may be invested: "But exclusive in every case of the securities of the corporation." ‡ The conservation of these funds and their use for the purposes intended require honesty among city officials, scientific and accurate accounts, and a certain amount of publicity or outside control of a disinterested and adequate sort. Absolute honesty in every official is not to be expected, and accounts are far from being satisfactorily kept. To provide for these deficiencies, Ontario, Canada, for instance, has enacted that persons who are responsible for diverting money from sinking funds are not only liable for the amounts diverted but are disqualified from holding municipal office for two years. § Moreover, failure to levy the amount required to be raised for sinking fund purposes in any one year brings disqualification for office for two years upon the members of the

* "Sixty-five cities reported city securities alone as constituting the assets, other than cash balances, in their sinking fund; eight cities reported other investments, but no city securities; 38 reported both city securities and other investments; and 43 cities reported cash as the only asset." "Financial Statistics of Cities having a Population of over 30,000," 1910. Bureau of the Census, Washington, 1913.

† Chamberlain, Lawrence. "Principles of Bond Investment," 1911, p. 214. *Vide*, also Chandler, Alfred D. "The Metropolitan Debts of Boston and Vicinity, Brookline, Mass.," 1905.

‡ Quoted in Biddell, Geo. "Local Loans in England," p. 334. Biddell in commenting upon this and other clauses remarks that they "are the best extant with regard to sinking funds." *Ibid*, p. 41.

§ "Consolidated Municipal Act," 1903, Sec. 418. 3 Ed. VII, Ch. 193.

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council so neglecting it.* The same province has adopted a further provision in order to guarantee the continued existence of such a fund after it has been raised. Section 8 of The Ontario Municipal Securities act † allows the deposit of such funds with the treasurer of the province, while section 11 ‡ requires that a return shall be made to the treasurer of Ontario showing whether the sinking fund for the year was raised, how it was applied or dealt with, and the conditions of the investments in which the funds were made. The present movement in the United States looking toward uniform accounts for municipalities and systematic reporting to a central administrative body is also a distinct step in the direction of guarding adequately the interests of the taxpayers.

The creditor, on the other hand, has little more than passing interest in the strict maintenance of these funds. The taxing power is most generally adequate security for the liquidation of his claim. Government solvency "depends wholly upon the efficiency of the taxing power of the government and the wealth of the private citizens." § Generally speaking municipalities have but one way of meeting their debts. Creditors rely almost wholly upon the power of taxation and upon the probable continued existence of taxable values.

Another difficult problem in connection with public debt is the determination of the proper time in which debt payments should be made. Theoretically there is no relation between a sinking fund and the life of an asset. The purpose of a sinking fund is the payment of debt; the purpose of a depreciation fund is to secure the maintenance of the efficiency of property. The latter is calculated almost wholly according to its "use" or "life." But a public debt must be paid, and the chief consideration in determining the proper time for payment in respect to depreciating property is its life. Not all properties, however, depreciate with the same rapidity; indeed, some do not depreciate at all, but on the other hand constantly appreciate in value. There can be no one period, therefore, for debt redemption that will suit all municipal properties. Twenty years duration for bonds issued to macadamize a street is too long, because on two or three

* *Ibid.* Sec. 418 (5).

† 8 Ed. VII, Chap. 51 (1908).

‡ 8 Ed. VII, Chap. 51, as amended by 9 Ed. VII, Chap. 76, (1909).

§ "Statistics of Cities with Population over 30,000," 1907, p. 18.

occasions during this period the necessity will arise for repeating the improvement. On the contrary, twenty years is too short a time for bonds issued to purchase land for a city wharf or park, because these properties will almost surely appreciate in value. And yet in Wisconsin, for example, cities are borrowing for all city purposes on twenty-year bonds. This is wasteful, because of the enormous loss through interest payments, and unscientific because of the violation of the canon of taxation—realizable equality.

Today the redemption periods concentrate on twenty and thirty-year periods. This would not be true if there existed for each state a competent authority, disinterested in unduly extending the period, whose duty it was to make the duration of loans roughly equal to the life of the property acquired by borrowed money. Questions of depreciation, involving as they do wear and tear, obsolescence, the effect of invention, changing methods in the solution of problems, etc., are so complicated that a close approximation to the life or the utility of properties can be made only by experts. To leave this problem for local officials to solve is equivalent to leaving it unsolved and to furnishing the opportunity for the abuse of credit and waste of public money.

England has set an example in this respect after which it would be well to pattern. Each general statute which confers borrowing power upon local authorities, specifies a maximum number of years for the repayment of local loans made under it. These periods vary from 10 to 60 years, and each act covers a number of purposes.* The determination for the actual period of each loan is left to the government departments—most generally to the local government board. This board is equipped with a "staff of engineers * * * amongst whose duties is that of holding local inquiries * * * into the circumstances under which it is sought to spread the expense of any work over a number of years by raising a loan for such work. Such an inquiry is in most cases obligatory under statute, if the new loan

* Borrowing is made to some extent under local acts, but the 60-year maximum is closely adhered to. It has been exceeded but four times. By standing Orders 173-A (1882), the rule was laid down that no committee should in any case allow 60 years to be exceeded or grant any period "disproportionate to the duration of the work to be executed, or to the object of the loan." "Report of the Select Committee on Repayment of Loans by Local Authorities, 1902," pp. iv-v.

The Public Works Loan Commissioners by section 11 of the Public Works Loan Act of 1875 are directed to have regard to the durability of the work when fixing the periods for which loans may run.

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will cause the indebtedness of the district to exceed one year's assessed value. At these inquiries the question of the probable durability and continuing utility of the work is gone into by the inspector, and it is his duty and that of the chief engineering inspector to advise the board as to the period for which the loans should be sanctioned." * Estimates of the utility, etc., of works are made item by item, or by groups of items, and an appropriate term for the repayment of the loan fixed. In order to avoid the multiplication of separate loans for items of different duration, the custom is to "grant an equated period for the whole loan which is arrived at by considering the sums required for each group of items and the term assigned to that group; but equation is not practised when the sums included in each group are large, and the local authorities express a preference for separate loans." † The following are a few of the purposes for which the Local Government board sanctions loans and the periods usually allowed for repayments: Baths, 20 to 30 years; boats, 10 to 15 years; buildings, 5 to 40 years; carts and vans, 10 years; clocks, 10 years; culverting watercourses, 30 years; electric lighting, first instalment, 25 years; gas fixtures, 2 to 30 years; markets, 20 to 60 years; land, 60 years; library books, 5 years; machinery, 10 to 20 years; street improvements, 10 to 30 years; water supply, 5 to 30 years, etc. ‡

* "Report of the Select Committee on Repayment of Local Loans by Local Authorities," 1902, p. iv. The committee thinks it "impossible to suggest any more thorough method of arriving at the necessary calculations in the first place than the local inspections and inquiries now held by the local government board." . . . *Ibid.*, p. xii.

† *Op. cit.* p. iv. The following is an example of an equated period for a loan for gas works purposes according to the method followed by the local government board, *ibid.* Append., I, p. 261.

| Description of work | Estimated cost | Usual term | |
|---------------------|----------------|-----------------------|-----------|
| Buildings | £2,500 | times 30 years equals | £ 75,000 |
| Mains | 1,245 | " 30 " | 37,350 |
| Gasometer | 1,500 | " 30 " | 45,000 |
| Condensers | 530 | " 30 " | 15,900 |
| Purifiers | 1,000 | " 20 " | 20,000 |
| Benches | 1,200 | " 15 " | 18,000 |
| Meters | 530 | " 10 " | 5,300 |
| Retorts | 600 | " 2 " | 1,200 |
| Total | £9,105 | | £ 217,750 |

NOTE—217,750 divided by £9,105 equals 23.9. The period accordingly allowed is 24 years.

‡ *Op. cit.* Appendix I, pp. 259-61. The following is a rough estimate of the proportion which various periods hold in the loans of the leading English local authorities:

| Duration | Proportion | Duration | Proportion |
|----------|--------------|----------|---------------|
| 5 years | 0.1 per cent | 30 years | 12.0 per cent |
| 10 " | 0.2 | 35 " | 1.0 |
| 15 " | 0.6 | 40 " | 22.8 |
| 20 " | 2.1 | 45 " | 4.1 |
| 25 " | 9.0 | 50 " | 44.0 |
| | | 60 " | 4.0 |

The Accountant, London, Vol. 37, p. 162.

Thus in England a conscious attempt is made to adjust the period to the life and the utility of properties acquired thus to equalize tax burdens between the present and the future taxpayer. There are no valid reasons why the same could not be done with us, and there is every reason why it should be done. Borrowing then becomes an alternative to taxation and not a device to escape taxing.

Our general conclusions respecting the time of debt payment may be summarized as follows:

(1) Debts should be paid within such periods as experience and prudence dictate, with the aim in view to deal fairly with the present and the future.

(2) When properties acquired are of a kind which depreciate and will need to be renewed at frequent intervals the loans should be paid within their life or utility.

(3) Where properties are of a more permanent character the periods which they are allowed to run should be proportionately longer, approaching a perpetual debt for such things as land for parks, etc.

(4) A reasonable scale could with little difficulty be decided upon by an expert board, and if enforced would go far toward putting municipal debt payment on a scientific basis.

(5) All things considered, serial payment is preferable to sinking fund payment for public debt.

Another question arises in connection with the payment of public debt which is not covered by constitutional provision, and one that most individual localities do not solve. It is the determination of the relation of sinking funds for productive and for unproductive properties, and of sinking funds to depreciation funds. Sinking funds are to pay off debt, but debt for unproductive and for productive property raises different questions and calls for different treatment. Sinking funds, to be built up from the general tax levy, are required for most loans irrespective of the uses to which the proceeds are put. There is nothing in our state constitutions or our laws generally which provides for separate treatment of productive or unproductive loans in this regard. Should sinking funds for productive properties be collected from the taxpayers *per se*? Such procedure is manifestly unjust unless they and consumers are identical in personnel. This is seldom the case. If debt for certain prop-

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erties is not to be counted as debt, in the constitutional sense, because the properties are revenue bearing, not only should the bonds sold to procure such properties be secured by their earning power or the properties themselves, and not by the tax rate, but the prices of the commodities or services furnished to the consumer should not only cover the cost of maintenance but sinking fund charges as well. This fund, although built up for the most part from the earnings of the properties, might be supplemented by the difference between the rate of interest at which the city is able to borrow for this purpose and the rate of interest that would have to be allowed on the bonded debt of a private company.

Ordinarily the accumulation of sinking funds begins at the time moneys are borrowed, but in the case of productive properties it could be well deferred until these become producing agents. This would be true, however, only on the supposition that the fund comes out of the revenues of the properties. Moreover, the complicated questions of depreciation funds and their relations to sinking funds in the cases of productive properties call for some attention. Should both charges be required? Private corporations, with which publicly-owned utilities have to compete, do not ordinarily carry sinking funds as such for the retirement of their bonds, but at their maturity they either fund them, or pay them with the proceeds of new issues. But this practice is not allowable as respects public debts, and justly so. Is it just to the present generation to hand over to the future fully-equipped operating utilities absolutely free from debt? These problems, important to the taxpayer, and involved in the subject of payment of public debt, are not solved by the present constitutional provisions nor are they being solved by the bulk of municipalities undertaking productive enterprises. No solution can be found for them, it is maintained, outside of an especially drawn statute administered by a board or boards with powers sufficiently broad to cover not only the authorization of borrowing, the determination of the kind of credit instruments used, and the periods which they are to run, but also the power to evaluate public properties, to accept or reject the plans of proposed undertakings, and to guarantee the legality of bonds or other instruments issued.

Powers similar to these conferred upon administrative bodies

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are not uncommon. Outside of the United States regulations similar to these are the rule. In England the local government board not only authorizes municipalities to borrow under general statutes but in a general way works out the details of proposed undertakings by a competent corps of engineers and fixes the periods which the bonds sold to procure the funds are to run. In much the same way these functions are performed by administrative authorities in France. In Ontario, Canada, the Ontario Railway and Municipal Board* is authorized to supervise local municipal accounts and to study the rates charged for municipal services in order to determine whether the utilities are operated in such a way as to pay the debt, together with the cost of maintenance and operation, or whether the rates are too high or too low.† The board is also empowered to guarantee the bonds issued by municipalities, so that their validity is not open to question in any court on any grounds whatsoever.‡

To confer similar powers upon administrative boards in the United States would be a distinct step in the right direction. In some of the states the nucleus for such control exists. In other states the machinery exists in all but perfected form. In Wisconsin, for instance, the tax commission and the railroad commission act in coöperation in evaluating public utilities. The tax commission uses the value for tax purposes while the railroad commission considers the value in fixing reasonable rates. The tax commission supervises municipal accounts and has the power to install accounts, while the railroad commission requires public utility corporations, both municipal and private, to keep their accounts on forms provided by it and to report regularly to that body. In that state, therefore, the foundation for an almost perfect control and direction of municipal finance has been laid. What is necessary further is the removal of the constitutional limitations on municipal debt, the passage of a general statute covering cities when fully classified, and the conferring on the tax commission and the railroad commission, acting together, such other powers added to those which they now have, acting separately, essential to a complete regulation of municipal debt. Such control should cover the total amount of debt obligations allowed, both temporary and funded,

* Organized in 1906, 6 Ed. VII, Chap. 31.

† 7 Ed. VII, Chap. 38, amending 6 Ed. VII, Chap. 31, sec. 57.

‡ 8 Ed. VII, Chap. 51.

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the amount for each property or use, control of accounts both as to form and publication, marketing securities, and their certification as to legality, etc.

With the establishment of a system of control such as is here referred to for one state, and the inauguration of a scientific and economic use of public money, many of the problems of municipal dishonesty, with their source in incompetency and graft, as well as those other problems associated with the prevalent tendency to borrow too much and to postpone payment too long, would gradually be solved. Cities will continue to grow, and the demands upon the public treasury will increase. If these are to become business units then business principles must be adopted and administrative devices multiplied and perfected. Until these problems are solved public moneys will be wasted through debt contracted and unscientifically handled, and borrowing power will be abused and the taxpayers pay the cost. Until some such change is made the fixed percentage of debt to assessed value will serve to handicap some municipalities, while leaving to others too extended borrowing powers, debt will be used where taxation alone is legitimate, sinking funds if provided will be used to pay current expenses, money will be wasted by borrowing when market conditions do not justify loans being made and by undertaking enterprises which are uneconomic both as to the types undertaken and the services rendered. The data and experience which a board or commission of the type indicated would accumulate would in a short time be of inestimable value, not only in directing municipalities as between private and public ownership and operation, but it would also serve as scientific information upon which to build standards of efficiency in public endeavor.

In marketing municipal bonds local authorities, through their representatives, enter the money market and bid with private corporations and others for command of the available capital.* Practically no municipal bonds find their way to the stock ex-

* *The Commercial and Financial Chronicle*, Vols. 88, 90, pp. 113, 121 respectively reports the following municipal bonds sold from 1892-1909 inclusive; thousands omitted:

| | | |
|--------------------|--------------------|--------------------|
| 1892.....\$ 83,823 | 1898.....\$103,084 | 1904.....\$250,754 |
| 1893..... 77,421 | 1899..... 118,113 | 1905..... 183,080 |
| 1894..... 117,176 | 1900..... 145,733 | 1906..... 201,743 |
| 1895..... 114,021 | 1901..... 149,498 | 1907..... 227,643 |
| 1896..... 106,496 | 1902..... 152,846 | 1908..... 313,797 |
| 1897..... 137,984 | 1903..... 152,281 | 1909..... 332,476 |

changes,* but are sold direct to banks,† trust companies and saving institutions only to be resold to the public to serve as investments for their savings, or to be used in National banks as security against government deposits. No difficulties are experienced in selling municipal bonds providing there is a market for securities at all, because the form of the bond is desirable and the security is almost perfect. William A. Prendergast, when comptroller of the city of New York, speaking of the bonds of that city said, "There is no better security in the world. Nothing less than a cataclysm so general in its effect as to be nationwide can seriously affect it."‡ What is true of New York city is in large measure true of the great bulk of growing cities in the United States. It is especially true of the large cities whose bonds are constantly before the people and whose continued growth is assured, whose properties are valuable, and whose machinery of taxation is well developed.

If bonds are issued according to law, if they are within the debt limit, and all legal requirements have been properly complied with, the security is nearly perfect, for the holder can compel payment by resort to the courts. Taxes are a lien prior to all other claims and their levy is mandatory. But the fact that bonds are within the legal limit of debt, and issued according to law, although certified to by appropriate officials at the time bids are made, must be verified by the buyer, and their validity is often not easy of proof. "Municipalities are not held to a strict accounting of debts and obligations incurred, unless the same are legally incurred, and it has too frequently happened that municipalities have sought (and in cases succeeded) to avoid their just obligations upon purely technical grounds."§ "Opinions on the subject vary, but anywhere from 20 to 50 per cent. of the aggregate municipal bonds are defective in the procedure of their issue. That is to say, flaws are detected by

* Of the gross amount of negotiable securities of \$25,314,429,058 admitted to the New York Stock exchange as of June 6, 1910, state bonds constituted but \$85,403,943; New York City bonds \$422,614,600, and other city securities \$19,455,000.

† Of the \$60,000,000 of 4¼% bonds sold at 100.94 by New York city in the spring of 1911, and which were oversubscribed five times, \$48,000,000, or 80% went to investment banking houses; \$11,500,000 or 19.25% to insurance companies, and only \$500,000, or 0.75% went to private investors. "The Recent New York City Bond Sale"; Escher, Franklin, in *Harper's Weekly*, Feb. 11, 1911, p. 22.

‡ *Collier's Weekly*, May 6, 1911, p. 34.

§ Squire, A. "Essential Recitals in Various Kinds of Bonds," *Annals of the American Academy*, etc., Vol. 30, p. 254.

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attorneys in their examination."* Of course municipalities may be made the basis of civil procedure in the case of bad faith, and this helps to compensate for the disadvantages which creditors experience through changing administrations, new policies, etc., and the fact that they must scrutinize the legality of the issues. The present debt limits, which at best provide against bankruptcy, and the presence of the taxing power make an investment in municipal securities almost second to none. Yet they are not what they might be to the creditor and far from equally advantageous to the debtor.

The one supreme fact in which the creditor is interested is the right to enforce the use of the taxing power. Indeed, it may be said, one of the main purposes of the debt limit is to insure the existence of such a proportion between the amount of indebtedness and taxable wealth, that the debts contracted will in all cases be paid. This is another safeguard extended to the bondholder. True it prohibits in most instances a too flagrant use of the borrowing power, but at the same time it woefully lacks all marks of an intelligent administrative policy. Not content with making the bonds in all cases a lien on taxable property an added precaution is taken to prohibit this mortgage from tempting the taxpayers to repudiation. But what of the protection to the taxpayers? Whether the asset acquired from the use of borrowed funds is properly used, whether it is wasted or ruthlessly destroyed, the creditor cares little. His security is certain so long as taxable private wealth endures. Even in these comparatively few cases where bonds are seemingly based upon the earning power of municipal utilities—since they are counted outside the constitutional debt limit, if they pay the interest on the bonded debt, and contribute to the sinking fund a sufficient amount to pay the bonds at maturity—the creditor is safeguarded by the pledge of the faith of the issuing corporation in case the properties do not make such contributions. In any case, the existence of taxable value upon which the city may be legally compelled to levy taxes is the source of the security and not the fund accumulated for its payment.

Negotiability is always an important factor in the value of

* Lownhaupt, Frederick, "Municipal Bonds; Facts Regarding their Issue and their Security," Booklet No. 4, *Moody's Mag.*, 1911.

any credit instrument.* The security of two issues may be identical, and yet the bonds of well-known places or places near financial markets have a greater negotiability and hence greater value than those from places not so well known or so advantageously located. The market for municipals is narrow, and the adoption of any measure which will widen it cannot but react upon the demand and through it upon their value. There is no necessary reason why the bonds of a small village whose population is enterprising, whose affairs are well managed and whose growth is certain, ought not to command as low an interest rate as those of large cities, providing they are issued with as great a discrimination as respects purpose, form and amount and possess equal negotiability. Yet such is strikingly not the case. A distinct step toward giving municipals these characteristics would follow the certification of their *necessity* and their legal validity by some recognized competent centralized authority. The fact that such securities existed would be advertised broadcast by financial houses and would react both to the advantage of the creditor in a wider market and to the debtor in a reduced interest rate.

Such has been the experience in those countries where certification has been put on an efficient basis. The Ontario Railway and Municipal board say of their experience in this matter: "A great many applications were made to the board, although there were no irregularities in by-laws or the debentures, in order to secure the certificate of the board, and thus enable the municipalities to obtain the highest market price for their securities, and to facilitate their sale, and make their transfer more convenient and inexpensive. Not only have the municipalities received a better price for their securities, but a great saving of expense has been effected by the act. It is estimated that the enhanced price and the saving of expense to the municipalities will amount to thousands of dollars each year."* But the power to certify the legality alone is not sufficient. Its necessary complement is the power to certify the *economic necessity* of debt contraction, as well as to prescribe the amount and form of debt which is allowed. In these respects the judicial review provided for and the powers given to the supreme court

* *Vide*, "The Better Protection of Municipal Securities," *Bankers Law Journal*, 1907, Vol. 24, p. 785. This is the report of the Committee on Municipal Securities to the executive council of the American Bankers association.

* "Ontario Railway and Municipal Board, Third Annual Report," 1908, p. 12.

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in the state of Georgia to validate municipal bonds, as well as the law of Colorado which requires that refunding bonds be registered by the state auditor, are defective.* The same may be said of the Texas law, which gives to the attorney general the power to validate municipal bonds, as well as of those parts of the constitutions of North Dakota† and Oklahoma,‡ which provide for bond validation.

What is to be counted as debt within the constitutional limit should not be a subject upon which the court's judgment must constantly be sought. The issues at base are economic and not legal, and while it might be possible for courts to formulate definite legal principles which would settle most of the difficulties arising under the present hodge-podge of legislation, they have not so far done so.§ The provisions governing debt contraction should be so definite and unmistakable as to prevent undue expansion by resort to the courts. Borrowing for legitimate purposes and in legitimate amount as demonstrated by sound policy and needs ought not to be prevented by rigid constitutional provision, nor debt contracted in good faith and after due consideration be invalidated because of some minor errors that may have crept into either through neglect or oversight during the process of issue. As it is today, such errors are sufficient to invalidate the evidences of debt in the hands of innocent holders,|| and to involve the taxpayers in wasteful and unwarranted expenditure. Too often, no doubt, municipal officials have taken advantage of this fact and either through acts of commission or omission, have been able to sell worthless securities. This fact, together with the enormous amount of borrowing by co-terminous and conflicting jurisdiction for a multitude of purposes has made it necessary for bond houses in effect to validate every issue which they purchase. This is expensive and the costs are paid by

* *Vide*, "Report of the Committee on Municipal Securities to the Executive Council of the American Bankers' association." *Bankers Law Journal*, Vol. 24, p. 758.

† Constitution, 1889, sec. 187.

‡ Constitution, 1907, Art. x, sec. 29.

§ "There is no established rule of construction which the courts have adopted in defining the words [What is debt in the constitutional sense]. The desire on their part to limit the legal indebtedness of municipalities, or to compel the payment of a moral obligation rather than any fixed rule of construction, has at times influenced their decisions." Abbott, Howard S. "A Treatise on the law of Municipal Corporations"; St. Paul, 1906, Vol. I, pp. 334-5.

|| "It is agreed that where there is no authority for an issue of municipal bonds, that the holder, however full of faith, is not protected and the bonds are void in all hands." Hill, John P. "The Advisability of Registering Negotiable Coupon Bonds." *The Green Bag*, Vol. 18, p. 14 (1904). Cf. Simonten, T. C. "A Treatise of the Law of Municipal Bonds" (1896) Sec. 124.

the debtor public. A question essentially economic in all its phases should be solved by resort to economic principles; as it is today, it is primarily a question to be worked over and dissected by the courts.

Municipalities must borrow money. The securities which they issue are possessed of those qualities well suited for investment purposes. Some method should be adopted which will check not only the extravagant use of municipal credit and make it impossible for city officials, either through innocent or wilful misconduct, to flood the market with questionable securities, but which would also determine the procedure of issue and legality of security. A possible controlling agent was suggested above, and in a broad way the powers indicated which are necessary for scientific control. The problem is the adjustment of local debt to the accepted and developed lines of private finance, an adjustment in which the interests of both creditor and debtor are fully conserved and guaranteed. By such a reform, expansive law suits over the legality and validity of contested bonds, far-fetched judicial decisions, counting this and that without or within the debt limit in order to make room for some needed improvement, or to curtail an undue disposition to borrow, would in large measure be displaced by uniformity, precision and certainty.

The problems sought to be emphasized, therefore, are problems of control. Control cannot come through blanket provisions which affect the amount of debt only and ignore the technique of issue. Borrowing is a legitimate method to provide for large capital expenditure; it is nothing more than a simple financial device, commonly employed in our whole industrial system. Adequate and enlightened control must be addressed to the technique of debt creation where the problems of equalizing tax burdens between the present and the future show themselves through the time and method of debt payment, as well as to the technique of borrowing where the relations of debtor and creditor are revealed in the determination of an interest rate.

Public debt is necessary to our local economy. Accurate accounts, publicity and control, so vital as respect current revenue and expenditure, become doubly necessary when debts are incurred for vast undertakings and sinking funds are accumulated

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for their payment. Public expenditures are increasing *pari passu* with the function of public powers. Larger and larger amounts of income are being diverted from private into public channels, and borrowing is more and more indulged in. Just as there can be no fixed percentage of public to private income, so there can be no fixed relation between borrowed funds and the total contribution which a people are willing to make. The necessary proportion must vary from time to time and from district to district. Neither can debt be made a certain percentage of the assessed value of property. The criterion for a proper measure of the relation of public to private income is service rendered, whether public income shows itself in taxes paid currently or in indebtedness contracted. Service is the guiding principle, and the measures undertaken to insure this in the form of checks upon the wastefulness of public money, whether by unreliable, incompetent or crooked officials or by meaningless accounts, etc., are likewise applicable to the control of public borrowing.

Our point of view may be summarized in the contention that public borrowing is neither a blessing nor an evil, but a legitimate financial device useful to some political units, indispensable to others, and harmful to still others, which requires for its proper control administrative talent of the highest type. Not only is the present constitutional control theoretically wrong, but as it operates it is open to the most serious objections. As a scheme of regulation it absolutely fails of its purpose. It was designed to prevent abuse of public credit, and it was thought this end could be realized by limiting the amount to be borrowed. In some cases, not only have the abuses but also the uses of credit been prevented; while in others its use has been flagrantly abused in spite of the limitations. These were developed originally of a philosophy which stamped public debt as a public evil, and this philosophy still retains its hold upon us.

The problems in public debt are, however, broader than curtailment of use; they involve regulated use and call for immediate attention.

Value of Use of Color in Making and Verifying Accounting Records

BY ERNEST H. COOPER

There was a time not far remote when most business enterprises were largely run by guess work. One result of this practice was that in many cases large amounts of capital were wasted on unprofitable undertakings before it was discovered that the object of business—namely profit—was not being attained. In other cases many profitable undertakings were losing money on certain classes of activities while making large profits on other classes of transactions, and thereby reaping a profit. No mariner would put to sea without a compass, and modern business men now realize that they cannot run a business successfully without the compass of fact to be had from complete books of account. Without guiding information to be had from such books of account it is not surprising that over 90% of all business undertakings in the past have failed.

Many causes in recent years have created a larger demand for facts required in safely piloting business undertakings over the rough seas of commercial endeavor into harbors of financial success. One of these causes is efficiency, which, in its last analysis means effectiveness. This word efficiency has been almost overworked by modern business men, if indeed it is possible to do this.

The demand for effectiveness calls for facts of business operation which reflect its efficiency or a lack of it. The tremendous growth in the size and the diversity of interests of present day business undertakings has brought about a larger demand for information by which to guide business than has ever been known in the history of commerce. This increased demand for information of all the activities of business has made necessary more elaborate records and classifications of records than was previously required. In the accountant's constructive work it is his constant endeavor to design records which will give the most complete information desired for the management of business with the least expenditure of time and effort. The account-

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ant must not fail to take advantage of every known principle or device to bring about desired results.

It is the purpose of this paper to emphasize the use of color in the construction and verification of accounting records. Perhaps the most common, and oldest, use of color in accounting records is the use of colored inks—red and black or blue—to show differing classes of entries in books of account. It may be stated that it is the tendency among American accountants today to use less red ink than was the custom. The evolution of the adding machine shows the value of color in making classifications or distinctions. The old style machine had either white or black keys across the keyboard. A late model of one of the leading machines has in white the first two rows of keys on the right, for cents. The next three rows are for units, tens and hundreds are black. The three columns to the left of hundreds are white, and the last two columns to the left are for numbers not to be added, and also the error keys, are red. It is more difficult to make a mistake on this machine than it would be if all the keys were of the same color.

A certain department store uses this form of sales-check for cash and charge sales, also for returned sales. No system of distinguishing these entries as "cash," and "returned sales" would be as infallible and economical as the having these checks of different colors. In the particular case referred to the cash-sales checks are white, the charge-sales checks are pink, and the credit sales checks, made out for returned sales, green. The original sales-checks are posted direct to customers' accounts. The most careless bookkeeper would seldom, if ever, post a pink ticket to the credit of a customer's account for a green one to the debit side, after he had become familiar with the meaning of the colors used.

In one of the government offices at Washington, where returns are received semi-annually from departments, of the army, the status of each return is shown at a glance by the color of the paster on the front lower edge of the manila envelope in which the return is filed. If the return has not been examined, no paster appears upon the lower edge of the envelope. If, after examination, it is "suspended" pending a reply as to errors found therein, a green tag is pasted over the front lower edge of the envelope. When the return is settled, a blue paster is placed

over the green one and becomes a permanent indication showing that the return has been examined and settled. In this case other pasters are put around the top front edge to indicate the classification of the return. White pasters around the top front edge indicate infantry returns, yellow cavalry returns, and blue indicates post returns.

It is a frequent occurrence in business concerns making shipments over different railroads or boat lines that their truckmen make mistakes in the delivery to freight houses. A method of diminishing such errors to a minimum has been devised and tried with success. Each railroad over which the business house is accustomed to ship is assigned a distinctive color. Each color is associated in as many ways as possible with all freight routed over that railroad. The routing labels, dray tickets, and if desired even the shipping and packing orders, are of that color. With this system it is difficult for the most unlettered teamster to go wrong.

It is the present-day tendency among some large business organizations to make their systems stand as much as possible so that expensive help may be done away with, and also that changes in the personnel of employees may not interrupt or embarrass the routine work of the business. The more difficult it may be for those who operate a system to make mistakes the better the system. A new saleswoman will be accurate in making entries on pink forms for charge-sales and on green ones for returned-sales, whereas if she were required to write on the check "charge" or "credit," as the case may be, she would be more liable to make mistakes which would cause the ledger clerk or bookkeeper to go wrong in making postings.

The auditor's colored pencils and inks of various colors are valuable to him. When figures have to be checked a second time, as is frequently the case, (for many times the figures have been checked once in an endeavor to locate discrepancies before the public accountant is called in), it affords a clearer and more effective check to use a different colored pencil or ink the second time than to only make a different check mark. If cash entries are checked into the ledger with blue pencil or blue ink, and other credits are checked with red, it is easy to pick out journal and other credits for further scrutiny. Some auditors use a special colored ink or pencil for all items which they wish to

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further investigate. This facilitates quick reference to these items when going over working notes.

A certain department store was frequently in the position of trying to collect from a stranger for a C. O. D. package after the driver had left it by mistake, believing that it was a charge or cash-paid package. The use of an address label of a distinctive color for all C. O. D. packages solved this problem, for the driver could not see the name on the package without knowing from the color of the label that it was a C. O. D. package. It frequently happens that goods sold at a discount are returned for credit at full price. If a distinctive color is used for sales-checks of goods sold at a discount the chances of their being returned for credit at full price is reduced to a minimum.

Movable metal tabs of different colors, sometimes called "tickler tabs," are valuable to use in connection with card indexes and card ledgers. For example, in a card ledger with cards having numbers 1 to 31 printed across the top, a blue tab on number 20 may indicate that the account is due on that day. A red tab may indicate that the account is past due, that a draft has been drawn against it, and that if the draft is dishonored further steps are to be taken on that day; while a red tab may indicate that the account is long overdue and has been placed in the hands of attorneys for collection. A glance at these tabs on a card ledger will give the credit man or proprietor more information about the condition of accounts receivable than could be secured in hours by turning the pages of the ledger.

In a retail business house of large size the credit man used to prepare a daily statement of new accounts for the information of the bookkeepers. The credit man now uses a red pencil in O. K.'ing first charges on new accounts, using a blue pencil for other charges. By this use of colored pencils the time formerly required to prepare the daily list of new accounts is saved.

Specific applications of the use of color in accounting records and labor-saving devices are too numerous to mention. A selected variety has been presented here with the hope that from the uses mentioned the reader will get a view of the unlimited ways in which the accountant may make color serve his ends more effectively than any other agencies.

Cash Discounts*

BY ALEXANDER J. CONEN

The chief function of trading account is to show the relation of the "cost of goods sold," i. e., the "turnover," to the amount of sales, the difference between the two representing gross profit or loss (as the case may be) from trading transactions appertaining to the legitimate conduct of the business. To institute a fair comparison the objects compared should be viewed under analogous conditions, and to consider costs on a cash basis in relation to sales on a time basis (or vice versa) is likely to show misleading results. Similar complications arise when some items entering into the cost are bought for cash and others are on time. For example: In the business with which I am connected some of our raw materials are always bought "net, sight draft against bill of lading" (a trade custom), while others are bought on various terms, such as "net 30 days, or 1% ten days"; "net 60 days, or 1% ten days"; "net 60 days, or 2% ten days," etc. Under such conditions an accurate cost accounting cannot be reached except by reducing all items to a uniform basis, and to this end a cash basis commends itself as being best adapted and the easiest of attainment. An ideal "trading account" would be one in which both cost and sales values are reduced to a cash basis, and it is my purpose to show in this paper how this is comparatively easy of accomplishment.

As to cash discounts on purchases, where a concern makes a practice of discounting all purchases the matter resolves itself to a question of deducting the cash discount from the face of the bill before debiting same to its respective purchase account, or if a "cash discount" column is maintained in the cash disbursement book the total of said column should be credited to the purchase accounts at the end of the month. Where some purchases are discounted and others are not, or where none of the purchases are discounted a somewhat different arrangement will be necessary. In such cases, where an invoice is discountable the full face of the invoice should be credited to the

* Paper read before the Kentucky Society of Public Accountants.

Cash Discounts

creditor's account, but the purchase account should be debited only with the net amount of the invoice after deducting the allowable discount for cash, the remainder being debited to untaken cash discount on purchases.

I might mention that I am not satisfied with the word "untaken" in the title of this account, but for the moment I can think of no better term—possibly a more suitable adjective might be suggested by others. A cash discount column should be maintained on the cash disbursement book and the total of this column at the end of each month credited to "untaken cash discount on purchases." At the close of a fiscal period an inventory should be taken of the discounts available upon outstanding "accounts payable" in the purchase ledger. After crediting this inventory to "untaken cash discount on purchases" the debit balance of this account will show the amount the concern has lost during the fiscal period through its failure to take advantage of cash discounts upon purchases. As this account represents in reality the interest the concern has paid to merchandise creditors it should be classed as a "capital cost with interest."

Where goods are bought with extra dating, for example a shipment of April 1 on terms of "July 1, 10% ten days, or 7% four months," the cash discount should include not only the "10% ten days" but also the interest for the three months from April 1 to July 10 at such rate as the creditor allows for anticipated time. By this method of handling "cash discounts on purchases" the respective purchase accounts will show the actual cash cost of merchandise or materials, and where in the same line of business one concern discounts and the other does not, each has the same basis for figuring costs, etc.

Where a concern allows a uniform cash discount on its sales, such as 2% cash, it will only be necessary at the end of each month to charge the respective sales accounts with the regular rate of discount and credit—"untaken cash discount on sales" with the total of such discount upon the month's sales. Against this account will be charged the discounts actually taken by the customers. At the close of a fiscal period an inventory should be taken of the discounts to which the accounts receivable on the sales ledger are entitled, and by charging this inventory to "untaken cash discount on sales" the credit balance will indicate the amount the concern has made through the failure of its

customers to avail themselves of the cash discount. This, like "untaken cash discount on purchases" should be classed as "capital income," like "interest earned," because it represents the amount the customers have paid for the use of the concern's funds.

In case it should be deemed desirable to have the respective sales accounts show the total gross sales the monthly total of cash discounts, instead of being charged directly to the respective sales accounts they could be charged to "discount on sales," with a corresponding credit "untaken cash discount on sales," in which event the discounts actually deducted by customers, or others, would be charged to the latter account, while the account "discount on sales" would be charged at closing into "trading account," thereby having the same effect as deducting the discount from the sales accounts as first outlined above.

Where different cash discounts or terms are allowed it would be necessary to calculate the cash discount upon each invoice, allowing for unexpired dating, and while charging the customer the full face of the invoice, credit the respective sales accounts with only the net, crediting the amount of discount (in a column on the sales journal or otherwise) to "untaken cash discount on sales."

While this may appear a somewhat radical suggestion I believe its adoption would be of benefit to those desirous of getting accounting down to a fine point, and that it is especially desirable in lines of business where large discounts and long dating are given.

I wish to invite particular attention to the difference between the accounts "cash discount on sales or purchases" and "untaken cash discounts on sales or purchases." The former represents the total cash discounts available, whether taken or not, and the "trading account" accounts. The latter represent discounts that might have been taken, but which were not taken, and are capital income and cost accounts.

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EDITORIAL

Hands Across the Atlantic

It is always pleasing to be praised by a contemporary, and especially by one who claims for his people the initiative in any profession or material endeavor. So, therefore, when one reads laudatory observations, as in *The Incorporated Accountants' Journal*, of London, on the big results accomplished by the American Association of Public Accountants, based on the *Year Book* showing for 1913, it seems doubly gratifying. The publication named, dealing with accountancy as a learned profession, says that it is "well sometimes to extend one's outlook beyond the British isles," and that while the home society "possesses influential committees in the great dominions, * * * the outlook can be extended further, to other countries not owing allegiance to the British flag, * * * the principal of these, from the point of view of its importance in the world of commerce, being the United States."

The British accountancy publication referred to generously and in broad spirit devotes three columns of its space to a comprehensive article on the development of the American Association as shown by its *Year Book*, quoting liberally from expressions of association members and officials as to the fundamental

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value of economics as the basis of education in accountancy compared with years of practical training and theoretical preparation to make applicants qualified for acceptancy in the profession.

The article in question finds it particularly "interesting" to compare most favorably to the former, the work of a "committee of professional accountants in a younger country" (referring to the part taken by the American Association through its legislative committee with reference to the income tax bill) with that of a committee "generally representative of the profession in the United Kingdom, such as the income tax committee of the Association of Chambers of Commerce."

Our British contemporary graciously remarks that "we have every reason to congratulate our professional brethren in the United States upon their achievements on behalf of the profession, and we shall watch the continued development of the certified public accountants on the other side of the Atlantic with pleasure and goodwill."

The JOURNAL appreciates the sentiment, and clasps the hand of its British contemporary with a reciprocal feeling of regard for its advanced professional principles.

A Sample of Government

Not all high government offices are sinecures. There used to be a belief that, once installed, the greatest burden of those controlling departmental work was the annexing the honorarium that attached to the office, leaving such labor as was essential to the performance of routine requirements in the hands of the vast clerical force of each one of the four branches of government. Not quite so in these progressive and exacting times. For instance, the department of the interior has been looked upon as a branch that has always had something or other to do with Indians, public lands, mining claims, and so on. It has a few other matters to adjust.

It may be the opinion of many that only private corporations, for profit, are competent to control intricate business affairs—the great big affairs of the country—but this seems

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to be brushed aside by the following epitome of a few of the matters that the interior department has under its charge, and to indicate, in sample at least, a summary of its activities and the exactions upon its director.

The secretary of the interior is the authority for this summary. He has been looking over his job and says that the interior department, among other affairs, cares for the Eskimo in Alaska and for the insane in the District of Columbia, as well as for 324,000 Indians all over the continent, having property in trust valued at more than \$1,000,000,000; it looks after the country's beauty spots (national parks); it distributes \$165,000,000 a year to pensioners; it issues an average of 3,000 patents a month to inventors; it issues patents for mineral lands, and takes means to prevent mine accidents; it has jurisdiction over the Indian and Negro schools; it controls the hot springs of Arkansas and the cliff dwellings of Colorado and Utah; it has control of the internal economy of Hawaii and Alaska; it measures the waters of a thousand streams, surveys the land of all the states, and prospects for hidden resources; it cares for 300,000,000 acres of public land (exclusive of Alaska) out of which each year approximately 60,000 farms are carved; it has a bureau of education; and there are divers other matters to which its direction is given.

The bigness of this business is suggestive. Where is the private corporation that would or could secure attention to this multiplicity of detail and unification of policy at the price paid to a departmental head?

Continental Combinations

While "Smash the Trust" is the battle cry of the politician in the United States, Europe seems to be entering upon a new phase of consolidated industries. The power of the "combine" in Germany never was greater than at the present time. In coal, in oil, in banking, in the expansion of its foreign trade, the German empire is no longer empirical, but is imperial in its constitution of harmonious units of action made up of similar interests working for the fatherland. And now Spain is falling into

line, and the syndicating of its industries is taking large proportions.

Combination of the sugar producers has resulted so satisfactorily that plans are maturing for other business lines to follow with organization on a large scale. The penalty of too great competition has been seriously felt. The paper millers have agreed to limit production and to compensate generously factories that have to produce relatively less than the others or that will close down entirely. One of the main points of the agreement is the complete stoppage of work in all the factories on Sunday, in itself a matter of tremendous import for economic and other reasons. The new organization will take the form of a sales bureau. It will be called the "Central Papelera."

The flour mills are also to be syndicated, and the system of sales and credit is to be completely changed. Attention will then be turned to other trades awaiting advanced modern methods.

Some Causes of Unemployment

One of the largest industrial establishments in central California finds that it will cost that company from \$10,000 to \$12,000 a year to insure under the new state employees' compensation law. This added expense cuts so deeply into the company's profits that it has decided to go out of business under such conditions.

A prominent blankbook manufacturing firm in the east, which has been highly prosperous and has proceeded satisfactorily with its employees, is winding up its business under dissolution proceedings because of the too frequent visits of the walking delegates coming to tell the proprietor what this, that and the other employe shall do and what shall be paid.

Increased intensity of competition in the sugar refining field is regarded as inevitably driving the weaker competitor to the wall. Yet this is only typical of a condition in which the rule of trade is "competition to the death," in order to prove that there is no combination. Under ordinary conditions the tolerant attitude of big business toward little business in the same field,

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with reasonable legal supervision of the rules of competitive conduct, leaves room for healthy, active survival of both. But where there is no limit to competition extinction seems to be certain sooner or later.

As laws are made nowadays, thus the philosophic observer reasons, they are enforced as well as formulated against the employer and investor, rather than with a view to encouraging capital to enter new or old fields. Hence the Morgans and the Standard Oil people lend their hundreds of millions to Greece and China, leaving the development of domestic industries to look out for themselves.

Income Tax Department

EDITED BY JOHN B. NIVEN, C. P. A.

There have been no publications of importance by the Treasury department during the past month, and the rulings which are printed in this number relate to matters of minor interest only.

T. D. 1950 informs the collectors of their powers in regard to granting extension of the time for lodging returns, and of the penalties for refusal or neglect to file returns within the prescribed time.

T. D. 1953 permits collectors to mark returns of citizens received from foreign countries up to March 31 as having the time extended to cover the period of filing such returns; and instructs them that letters, stating amount of income, received from the consular service and others residing in foreign countries, in reply to cables from the State department, are to be accepted as tentative returns, so far as the date of filing is concerned—to be substituted for the proper forms when these are ultimately received.

T. D. 1955 again extends the waiver of the requirement that numbers of bonds should be filled in on certificates to June 30, 1914.

It may be assumed that the Treasury department has now disclosed its complete interpretation of the law and that future rulings will be devoted to administrative details only, so that it now lies with the taxpayer to obtain the courts' relief from those regulations which he considers out with the powers devolved on the department by the law and elucidation of the various points in the law and regulations which are in doubt.

However, the present indications are that the first case to be laid for decision by the courts will be on the constitutionality and validity of the law itself and not upon its interpretation.

In this connection, two cases which may ultimately prove to be of vast importance have been filed within the past month. These are *Brushaber vs. Union Pacific Railroad Company*, filed in the United States district court for the southern district of New York, and *J. F. and H. E. Dodge, of Detroit vs. William H. Osborn, Commissioner of Internal Revenue*, filed in the Supreme Court of the District of Columbia.

In the *Brushaber vs. Union Pacific Railroad Company* equity suit the question of the constitutionality of the law is raised from many points of view. The complainant, a stockholder of the defendant company, asks that the latter be enjoined from voluntarily making the returns and paying the taxes imposed by the law, and he gives numerous reasons why his request should be granted. Included among the reasons given are found most of the points which have been used in argument against the act, and, while reserving any comments and criticisms to which the pleadings may obviously lend themselves, perhaps a brief mention of the points raised will not come amiss at the present time.

Income Tax Department

In the first place, the complainant avers that so much of the provisions of the law as seeks to impose a tax upon net income received prior to October 3, 1913 is unconstitutional and void, for the reason that such receipts had, prior to the date of the act, become property and capital and had ceased to be income, and such provisions were thus repugnant to and in conflict with the third clause of the second section and the fourth clause of the ninth section of article 1 of the Constitution, because they imposed a direct tax which had not been apportioned among the states according to population, and which had not been laid in proportion to a census or enumeration.

He further contends that the taxes imposed by the act are unconstitutional and void in that there are specifically exempted from the imposition of the tax certain organizations, societies, associations and other corporations which are direct competitors of corporations and individuals subject to the tax, and that the restricted powers of the Federal government do not permit of such exemption.

Again, he avers that the taxes proposed to be assessed and collected and the provisions of the law providing for the assessment of such taxes are unconstitutional and void in that they are inconsistent with and violate the provisions of the fifth amendment to the Constitution: that property shall not be taken without due process of law and that private property shall not be taken for public use without compensation, for the reason that said provisions involve discrimination and classification of the persons and corporations and of the incomes of persons and corporations within the scope of said provisions which are arbitrary and unreasonable and constitute class legislature. In justification of this averment he points to (1) the specific exemptions of \$3,000 and \$4,000, which he says are exemptions of amounts greatly larger than amounts the tax upon which would equal the expense of collecting—contended by him to be the only constitutional measure of exemption; (2) the denial of any specific exemption to a corporation; (3) the fact that, where a corporation has assumed and agreed to pay the tax directed by the Act to be withheld, compliance with the statute requires it to pay the tax where the creditor, although entitled to exemption in respect that his entire net income amounts to less than \$3,000, fails to file a claim to exemption with the corporation; (4) the fact that, in the case of a corporation indebted for more than the amount of its capital stock, the result of the operation of the act is to tax as income of the corporation monies received and disbursed not as earnings but as interest payments to its creditors, and which in the hands of its creditors are again taxed for the same year as income of the creditors; (5) the fact that while domestic corporations generally are restricted as above indicated in the amount they may deduct as interest, there is no such restriction on banks, banking associations, loan or trust companies; (6) the fact that corporations have to pay the normal tax on dividends received from other corporations, while individuals are not so taxed; (7) the provisions of the law with regard to the additional tax whereby discrimination and classification is made solely upon the basis of wealth and is not founded upon a

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difference that the restricted powers of the Federal government permit to be the basis of classification; (8) the discrimination between and classification into two distinct classes—owners of taxable income part or the whole of which is withheld at the source, and owners of taxable income no part of which is withheld at the source—whereby the former, unlike the latter class, is deprived of the use and benefit of the moneys so withheld during the period between the date of the withholding and the date it is actually paid to the Treasury; (9) the refusal to allow the specific exemption of \$3,000 or \$4,000 or the deduction of the amount of dividends received with respect to the additional tax; (10) the discriminations which are based solely upon the circumstance whether the husband and wife are living together or permanently apart; (11) the fact that a person from whom tax has been deducted at the source may have again to pay the tax on the default of his fiduciary or withholding debtor; (12) the benefit and advantage to one who owns his home over one who rents it; (13) the privileges extended to farmers, etc.

The complainant also contends that the act is invalid in that it unlawfully delegates to the secretary of the treasury to decide in certain cases whether accumulations of profits are unreasonable for the purposes of the business.

In the equity suit of *Dodge vs. Osborn* it is narrated that the plaintiffs are parties in business under the firm name of Dodge Brothers, and bring the suit as individuals and as partners and that the defendant holds the office of commissioner of internal revenue in the government of the United States, and he is sued in both his official and his individual capacity. The plaintiffs pray that Wm. H. Osborn may be made the defendant in their bill of complaint and required to answer thereto, and that relief be granted as follows:

(1) That the income tax law may be declared defective and inoperative, for the reason that it provides for the assessments of income taxes without an opportunity being given the individuals and corporations to be assessed to show what their assessments in justice and right ought to be, the law being in this particular in conflict with the provisions of the fifth amendment of the constitution before recited;

(2) That the act may be declared to be unconstitutional and void, for the reason that the discrimination in favor of corporations and against individuals and partnerships is not within the power conferred on congress to lay taxes, etc., or the power conferred by the sixteenth amendment to levy taxes on incomes from whatever source derived, and because the provisions of the act following are in conflict with the fifth amendment, namely:

- (a) For the levy of assessment and collection of an additional tax on the income of individuals exceeding \$20,000;
- (b) That, for the purpose of the additional tax, the taxable income of any individual should embrace the share to which he would be entitled of the profits if divided, whether distributed or not, of all corporations, etc., formed for the purpose of preventing the imposition of such tax through allowing the profits to accumulate; and
- (c) That it permit corporations to withhold from taxation such portion of their profits as may be reasonably necessary for the

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needs of the business and denies such privilege to individuals and partnerships.

(3) That William H. Osborn may be temporarily and perpetually enjoined from assessing plaintiffs or any other individuals or partnerships with any surtax whatever without first giving them proper notice of the time and place when and where they will be given an opportunity to be heard on the questions whether they are subject to a surtax and the amount thereof; and that he be likewise enjoined even after notice and hearing from assessing or collecting any surtax upon or against plaintiffs or any other individuals or partnerships similarly situated or circumstanced.

(4) That it may be further decreed that plaintiffs and other individuals and partnerships are entitled to withhold from income taxation such portion of their profits as may be reasonably necessary for the purposes and needs of the business in which they are severally engaged in the same manner as corporations, joint stock companies or associations engaged in the very same kinds of business are permitted to do.

The plaintiffs make numerous statements in support of the prayer of their suit, but these are not detailed, as sufficient information has been given to show the main line of their argument.

Cases laid on such broad lines as those that have been just indicated, should, if carried to the ultimate court of appeal, settle once and for all time the constitutionality and validity of the law; and the further progress in the courts of these two cases will be a matter of considerable interest to the public generally.

There seems to be some confusion in the minds of many as to the correct interpretation of what should be included under Item 6A in the corporation tax return, and to make the confusion worse there has recently been promulgated by a district collector of internal revenue a decision which is worth quoting. He says:

A corporation may deduct on this line the total amount of interest paid within the year upon all its indebtedness provided the amount does not exceed (at the rate paid) a sum not in excess of the interest upon its entire capital stock at the end of the year, plus half the interest-bearing indebtedness at the end of the year. In other words, if a company was paying a very large amount of interest on say \$50,000 capital and \$50,000 interest-bearing indebtedness, its interest deduction would be limited to \$4,500 in this case, provided the interest rate was 6%. This provision applies in cases where corporations are carrying a very heavy bonded indebtedness but would not affect ordinary cases.

This interpretation is so contrary to the plain meaning of the language used in the law that there does not seem to be any room for controversy on the point. The law provides that the taxable income of a corporation shall be ascertained by deducting from the gross amount of income received within the year from all sources * * * "(third) the amount of interest accrued and paid within the year on its indebtedness to an amount of such indebtedness not exceeding one-half of the sum of its interest-bearing indebtedness and its paid-up capital stock outstanding at the close of the year * * * ." It is evident that what is to be deducted is the interest paid on one-half of the sum of two amounts, *i.e.*, the interest-bearing indebtedness and the capital stock. To

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obtain the result arrived at by the collector the word "sum" would have to appear before instead of after the words "one-half," and the provision read the sum of one-half of the interest-bearing indebtedness and the capital stock. But of course the law is not so worded, and as it now stands its only meaning can be that the amount to be deducted is not to exceed interest on one-half of the aggregate of the interest-bearing indebtedness and the capital stock.*

Treasury Rulings

(T. D. 1950 February 19, 1914)

Time for filing returns of income, and penalties in connection therewith.

To collectors of internal revenue:

You are advised, and will so announce from your respective offices, that the law and regulations require returns of income for the taxable period, March 1 to December 31, 1913, to be made and filed on or before March 1, 1914. The law is mandatory and allows no discretion to be exercised by any officer. Section 3176, Revised Statutes of the United States, as amended and made part of the income-tax law, gives to collectors of internal revenue (they being satisfied as to the merits of the claim, and in the reasonable exercise of their judgment and discretion) authority to grant extension of time not to exceed 30 days from the time prescribed by law in which to file a return of net income, and then only in cases where such failure, neglect, or refusal is the result of "sickness or absence."

You are also advised, and will so announce, that there will be no change in income-tax regulations as they now exist prior to March 1, 1914, and that all persons and corporations required to make a return which have not as yet done so should make and file their returns at the earliest opportunity and on or before March 1.

Collectors will forward to this office immediately a report showing the number of returns filed in their respective offices as of February 20, 1914.

* Since the above was written a ruling has been made by the Treasury department on the question of the proper amount to be deducted as interest by corporations in their returns. The ruling was received too late to be printed in this number, though it may be said that generally it upholds the interpretation given by the collector as above quoted. It appears difficult to understand the mode of reasoning by which the above result is arrived at, unless it is held that the indebtedness is made up of various separate amounts and that it is one-half of the sum of these amounts that is to be added to the capital stock. However, the ruling fixes the position in the meantime, and it now lies with the corporations which made up returns on a different footing to make their interest deductions conform to the new interpretation.

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Penalties and additional tax, in connection with refusal or neglect to file return of income within the prescribed time.

As to corporations.—For neglect or refusal to make a return within the prescribed time, corporations are liable to a penalty not to exceed \$10,000; and in case of neglect or refusal to make, or for a false or fraudulent return made, 100 per cent is to be added to the tax; and in the case of neglect or refusal to make and verify a return within the prescribed time (except in case of sickness or absence) 50 per cent is to be added to the tax; and in case of an officer of a corporation or like institution charged with the duty and responsibility of making and verifying a return who makes a false or fraudulent return with the intent to defeat or evade any assessment or tax, he shall be guilty of a misdemeanor, and be subject to a fine not to exceed \$2,000, or to imprisonment not to exceed one year, or both, at the discretion of the court, together with costs.

As to individuals.—For neglect or refusal to make a return within the prescribed time, the penalty is not less than \$20 nor more than \$1,000; and in case of intentional neglect or refusal to make, or for a false or fraudulent return made, there shall be added 100 per cent to the tax; and in case of neglect or refusal to make a return within the prescribed time (except in case of sickness or absence) there shall be added 50 per cent to the tax.

(T. D. 1953 March 2, 1914)

Extension of time for filing returns under income-tax law by citizens of the United States living abroad.

To collectors of internal revenue:

Referring to that portion of section 3176, as incorporated in the income-tax law, which provides that—

In case of neglect occasioned by sickness or absence as aforesaid, the collector may allow such further time for making and delivering such list or return as he may deem necessary, not exceeding thirty days—you are informed as follows:

Various citizens of the United States living abroad were unable through such absence from this country to inform themselves as to the requirements of the law, and were also unable to obtain the necessary blank forms on which to make their returns of annual net income for the income tax. You are therefore authorized to mark the returns received from foreign countries after March 2 and up to and including March 31 as having the time extended to cover the period of filing such return.

The State department has cabled the consular service and others residing in foreign countries that they shall forward a letter, in which

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their income shall be stated, and that such letter will be received in lieu of the return so far as the date of filing is concerned.

Such letters are now coming to this office, and they are being forwarded to the various collection districts to be held as tentative returns until the returns on Form 1040 shall be received. The regular returns on Form 1040 when received should be attached to the tentative returns and both should be forwarded to this office with the assessment lists on which the same shall be listed. The date of filing the returns should be considered that on which such tentative returns were filed.

(T. D. 1955 March 10, 1914)

Extension to June 30, 1914, of waiver of T. D. 1901, Treasury requirements for the filling in on certificates of the numbers of the bonds of corporations, etc.

Notice is hereby given that T. D. 1901, issued November 28, 1913, waiving, until March 31, 1914, the requirement that the *numbers of the bonds* or other like obligations of corporations, etc., from which interest coupons are detached or upon which registered interest is to be paid shall be filled in on the certificates is hereby extended to Jun 30, 1914.

In all other respects the certificates referred to must be filled in accordance with the Treasury regulations before the coupons or orders for registered interest to which they may be attached shall be paid.

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EDITED BY SEYMOUR WALTON, C. P. A.

It will be seen that the meager information afforded by single-entry accounts, and the danger of mistakes arising from their lack of reliability, would render them almost useless when many complications enter into the transactions of a business. Although the necessity for a better system must have long existed, it was not until about four hundred years ago that any better method was devised. The introduction of the improved system, which has been given the name double-entry, was first made in Italy, but there seems to be some doubt as to its author, and of the exact period when it made its appearance in practice.

Double-entry is founded on the immutable principle in nature that every action must have an equivalent counteraction. In physics it is known as the correlation of forces. A given amount of force exerted in a certain way will result in an exact equivalent of other forces, a portion of which may be available for use either as electricity or light, and another portion be wasted as heat or the destruction of material through friction. If a belt runs from a pulley of 24 inches diameter with a speed of 50 revolutions per minute and an indicated horse power of 45, to a pulley 8 inches in diameter, the latter will have a speed of 150 revolutions per minute, but its horse power will be reduced to 15, provided friction is disregarded. The amount of work done is exactly the same in either case, 2,250 units.

In accountancy this principle is stated as the equilibrium between debits and credits. No debit or credit can be created without the simultaneous creation of an equivalent credit or debit. If a manufacturer buys a machine for \$1,000, he has added that amount to his asset of "machinery." If he pays for it in cash he has reduced his asset of "cash" by the same amount. If he buys it on credit, he has added the amount to his liabilities of "accounts payable." Therefore, at the time when he debits "machinery" with \$1,000, he must credit either "cash" or "accounts payable" with \$1,000.

A set of double-entry accounts may be compared with a pair of scales, one of which holds assets and the other liabilities. As all assets put into one scale are exactly offset by the liabilities put into the other scale, the scales will balance. If an additional asset is added to the "asset" scale, it is imperative that an equivalent asset of some other kind must be taken out of that scale, or an equivalent liability be put into the other scale, in order to preserve the equilibrium or balance. In the same way the addition of a liability must be accompanied by the abstraction of some other liability, or the addition of an equivalent asset to the other scale.

This inflexible relation between debit and credit is expressed by the

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term "double-entry." In order to preserve the balance of the accounts, no entry can stand by itself; it must be offset by an equivalent entry of an opposite character. For a long time after the adoption of the double-entry system this principle was rigidly adhered to in every individual case, a dual entry being made of each transaction, each member of the entry being posted to the ledger separately. As these entries were made daily the book in which they were recorded was called a "journal," a word of French derivation, being used to distinguish it from the "day-book," which was merely a collection of unrelated memoranda. The term "journal" entry has come to mean a dual entry, the debit and credit sides of which balance exactly.

ADVANTAGES OF DOUBLE-ENTRY

One of the most important advantages of the double-entry system is that the accuracy of the accounts may be easily tested. As each debit or credit, when made, is balanced by a credit or a debit, it follows that any collection of debits and credits, however large, or however complicated, must also balance. If the loads in a thousand small scales are in equilibrium, and those loads are transferred to the corresponding sides of one immense pair of scales, the large scales must also be in balance. Therefore when any number of equal debits and credits are transferred from the books in which they were originally entered, to a ledger, by the process known as posting, the ledger itself must contain an equilibrium of debits and credits; that is, it must be in balance. This equilibrium is tested by what is known as a "trial balance," which is a list of all the debit and credit balances on the ledger, arranged in two columns, one for the debits and the other for the credits. If both columns add up the same it proves that the ledger is a correct collection of all the items pertaining to the accounts, the only chance of an error being that a counter error may have been made, or that some item has been posted to the correct side of the ledger, but to a wrong account. As such errors are infrequent, the figures of the trial balance can be relied upon in the preparation of any kind of financial statement.

As single-entry is only the record of personal accounts and cash, it contains no information as to other assets or liabilities or as to any elements of profit or expense. Owing to the dual nature of double-entry, every element of a business must find expression in the accounts. A charge to a customer must be offset by a credit to a "sales account." The payment of any expense must be charged to some kind of an "expense account" more or less classified according to the character of the business or the desires of the proprietor. It follows that when the figures are assembled at the end of any fiscal period all the items that tend to increase or to decrease the final profits can be marshalled under appropriate headings, so as to disclose the effect of each one on the ultimate result. With this information in his possession the owner of the business can study each point with a view to eliminating as far as possible the causes of loss, and to stimulating those factors which make

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for profit. With similar information in regard to past years, he can institute comparisons which will disclose in what particulars he is falling behind, and in what he is making gains. By the single-entry methods he knows only the total of his profit or loss, and has no means of ascertaining the sources or causes of the profit or loss.

Another important advantage of the double-entry method is that items of expense or profit can be put on the books so as to affect only the fiscal period to which they properly belong. While a single-entry man might include deferred charges to operating and accrued accounts receivable among his assets, and accrued accounts payable and deferred credits to revenue among his liabilities, he is apt to do it because he has not progressed beyond the point of considering only tangible assets and actual liabilities. The single-entry man cannot get away from the idea that each element of his business must be looked at from the standpoint of cash. While he may take cognizance of wages accrued but not due,—because he knows they are virtually a cash obligation,—he probably will ignore accrued interest on a demand note payable, because he does not have to take any practical notice of it until he pays the note. Sometimes it is difficult to persuade even a man accustomed to double-entry that he must take his accrued, but not due, obligations into considerations. The secretary of a street railroad company made a statement of earnings for five months, in which he included all the cash receipts and disbursements and all the expenses for which bills had been rendered, but omitted the accrued interest for the five months on \$750,000 of bonded indebtedness at 5%, because the coupons would not be payable until the end of another month.

RULES FOR JOURNALIZING

Many rules have been formulated for making journal entries. The principal ones that have found favor are: Debit whatever comes into the business or costs the business value. Credit whatever goes out of the business or produces value for it. Or this:

| <i>Debit</i> | <i>Credit</i> |
|----------------------------|----------------------------|
| Increase of Assets | Decrease of Assets |
| Decrease of Liability | Increase of Liability |
| Decrease of Proprietorship | Increase of Proprietorship |

Or: Debit the account that received the benefit, and credit the account that yields the benefit. These rules are correct from an academic standpoint, but the difficulty is to remember the rule and to classify the entry to fit it.

PERSONIFYING ACCOUNTS

It is claimed by some that an easier way to make an entry clear is to personify all the accounts, by saying that Mr. Merchandise is the

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person to whom is committed the custody of the goods in which we deal, and Mr. Cash the person to whom we pay or from whom we receive the cash that is involved in our transactions. This becomes a little too complicated for most persons when an attempt is made to explain some of the more intricate entries, especially in closing the books.

There are occasions, however, when the fiction of personification becomes useful in clearing up difficult questions of analysis in the accounts. For instance, in determining what items belong in the "manufacturing," "selling," or "profit-and-loss" divisions of a revenue statement, it may clarify matters to imagine that we are dealing with one man engaged in the manufacturing department only, with another who is concerned solely with the selling, and with a third who is the proprietor or capitalist of the business. The manufacturer may claim that cash discount taken on purchases of raw material is a reduction of the price to be charged his department, while the seller may claim that the discount allowed on his sales is no affair of his, but that it must be charged, in the "profit-and-loss" division, to the proprietor, on the ground that it is necessitated by the lack of sufficient capital contributed by the proprietor to the business. Bringing the personal element into the question makes it more realistic than treating it in the abstract sense.

These and many other examples that might be given of attempts to explain debit and credit, show to what length the authorities are driven to form a working hypothesis which shall cover all the points of the subject.

DEBIT AND CREDIT

The difficulty seems to be that they all start with a wrong idea of the fundamental principles. Thomas Jones, who was one of the first writers on the subject, said: "All debts are not sums owing to us, nor are all credits sums we owe. These terms are used arbitrarily, and any attempt to exhibit them in one uniform relation of indebtedness must necessarily oblige us either to use terms of corresponding ambiguity, or resort to the personification of things which not only have no existence, but the indebtedness of which cannot possibly have any apparent influence on the end we aim to accomplish. In personal accounts they bear a literal meaning; and by analogy they have been extended to all other accounts; but the relations which constitute that analogy are too obscure to be of use as a guide to the student, and are more calculated to mystify than explain the subject."

Again, Charles E. Sprague says that bookkeepers call "all credit balances liabilities, although they know that some of those balances are not liabilities. Even admitting that there is a fictitious entity, it owes nothing to the real owners." He gives as the basis for determining whether an item is a debit or a credit six classifications, "debit expressing an increase of assets," "decrease of liabilities or a decrease of proprietorship," and "credit," the three opposites of these, as quoted above.

It would seem as if these more or less elaborate attempts to define

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and explain "debit" or "credit" would be unnecessary if we could find some method "to exhibit them in one uniform relation of indebtedness," which as we have seen Mr. Jones says cannot be done. In other words, if we can show that a debit is always something due to, and a credit something due from, the business the problem will be greatly simplified.

RELATION OF THE PROPRIETOR TO THE BUSINESS

To do this it is absolutely necessary to discriminate between the "business" and the "proprietor" who owns it. In speaking of this view of the matter, Mr. Sprague says: "I cannot see that it justified the inclusion of proprietorship among the liabilities. Surely the business does not stand in the same relationship to its proprietors or its capitalists as to its 'other' liabilities." What then is the relation of the business to the proprietor? If A invests a certain sum of money in a business to be managed by B, under the name of B & Co., the distinction between A, the proprietor, and B & Co., the business, is plain. A would charge B & Co., on his books, and it would be difficult to make him understand that B & Co. did not owe him the money represented by that debit balance. It is true that the account would not "stand in the same relationship" as other accounts that are of short duration, but that would not change its character as a debit. But if it is a debt on A's books, what magic is there in the word "capital" that changes its nature on the books of B & Co., except to classify it as the last debt to be paid, which is a difference in degree but not in kind? If this is agreed to, it seems equally true that when A invests money in the business of A & Co.—which he himself manages—he is acting in a dual capacity as A, the capitalist, and A & Co., the business. If the latter business goes into the hands of a receiver, all that is left when the "other" liabilities are paid would certainly constitute a debt of the receiver to A, and would be so treated and paid. The fact that A does not get any payment until every other claim is satisfied does not alter his status, any more than the status of second mortgage bondholders as creditors is altered by the fact that there may be only a partial payment to them possible after the first mortgage bonds are paid.

If the capital is acknowledged to be a debt of the business, our next concern would be with the nominal accounts, such as "rent," "wages" and "expense." That these are debts due to the business by the proprietor arises from the fact that the business is managed for account of the proprietor, who must eventually pay all its outgo and receive all its income. When the manager has expended various sums for rent, wages, etc., he is entitled to present a bill to the proprietor as an indebtedness of the latter to the business. The proprietor, while acknowledging the indebtedness, tells the manager that, since the actual money is not needed, he may charge the items to his account, but for statistical reasons to do so, not in one general account but in different ones, such as "proprietor for rent," "proprietor for wages," and so on. The manager, for the sake of brevity, drops the name of the proprietor, and

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keeps the accounts as "rent," "wages," etc. When the gross profits are ascertained, at the close of the fiscal period, they unquestionably belong to, are owed to, the proprietor, and the profit and loss statement is simply the statement of the proprietor's account with the business, in which, as in every other personal account, the debits and credits are offset, and only the balance is accounted for. That this balance is really a debt due by the "business" to the "proprietor" is shown by the fact that the latter can demand every cent of it in cash. That he allows it to be added to his original credit in a personal business—or in the case of a corporation allows it to be credited to a new proprietorship account called "surplus"—does not in any way alter its character as a debt of the business to him.

In the personal accounts any item for which payment can be demanded from any person is a debit, any item for which payment can be demanded by any person is a credit. In the impersonal, or nominal, accounts any item payment for which can be eventually demanded from the proprietor is a debit, and any item for which the proprietor can demand payment is a credit. No other touchstone seems to be needed to determine the true nature of any item.

The most severe test of this method of treating this matter would probably be found in explaining the asset accounts, and yet it is reasonable to say that if the business invests money in a building, machinery or material, for the account of the proprietor, the latter must owe the business for these things. If a reserve is set up for depreciation on building or machinery it must be a credit, for it is a payment due the proprietor for the use of the building or machinery, representing the loss of value to him consequent on such use. Another, and perhaps better, way to regard the credit to a "reserve account," is that it is not a true credit, but is rather to be considered as a deduction from the debit account of the asset to which it refers, and is expressed on the books as a credit purely for convenience.

In the same way any item may be satisfactorily explained if its real nature is ascertained. It does not seem an unreasonable thing to recommend the adoption of a theory which may be applied to every phase of a subject and fits them all.

EVERY DOUBLE-ENTRY A JOURNAL ENTRY

As the double-entry system requires an offsetting credit for every debit, it necessarily follows that every entry in such a system must be in essence a journal entry. At first, as we have said, this was actually the case, each separate transaction being represented by an individual journal entry. The first step in advance consisted in combining items of the same character into one entry for the transactions of each day. Thus, if there were twenty sales of merchandise in a single day, instead of making twenty separate entries, each one debiting a customer and crediting merchandise, one entry for the day was made, each of the twenty customers being debited, but merchandise given only one credit

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for the total of the day's sales. In the same way cash would be debited with the total receipts of the day and customers would be individually credited. The next step was obvious; instead of completing the journal entry by one debit or credit for a single day, the list of individual items was carried for a month and one posting of the total was made at the end of the month. As transactions increased in number, the journal was divided into several different books, one devoted to cash transactions only, another to sales, and a third to purchases, while the ordinary journal was continued in use for miscellaneous items, such as the transfer of entries from one account into another, either for the correction of errors or for the closing of one account into another. Such a journal is often called a cross-entry journal, as it is a mere record of transfers between accounts and does not register original transactions.

As soon as the journal was divided into several books it became possible to depart from the conventional form of one debit and one credit column, and to introduce as many columns as the needs of the business required. In most of the books the journal nature of the entries, while temporarily obscured, became apparent at the end of the month when the figures were assembled by totals. In a sales book containing a number of columns for different classes of sales, the journal characteristics appeared by the charge of the total of all the transactions to the controlling account of customers, and the credit of the totals of the various sales columns to their respective sales accounts. The same was true of a "purchase" or "voucher record," a "notes receivable register," or any others of the many forms into which the journal had become divided.

The advantage of this specializing of the journal was not confined to the possibility of varying its form. Each division being in a separate book, it became possible for all the books to be in use at the same time in the hands of different persons. In a large business this subdivision of the work is carried to such an extent that one person will often have charge of a single book, and will know nothing whatever of any transactions not recorded between its covers. Such a person is liable to become caught in a rut from which he may find it difficult to escape unless he has ambition enough to fit himself for something less monotonous and more remunerative.

JOURNAL NATURE OF CASH BOOK

The one book in which the journal characteristic seems to be lacking is the cash book. It is puzzling to many to understand why items on the left-hand page of a cash book are posted to the right-hand side of a ledger, and the reverse for the items on the right-hand page, when items in a journal are always posted to the same side of the ledger as the columns in which they appear in the journal. The difficulty disappears if the cash book is thrown back into its original journal form. That is, instead of recording the receipt of money from various persons by registering his name and the amount he pays on a single line, the full journal entries would be:

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| | | |
|------|----------|----------|
| Cash | \$100.00 | |
| To A | | \$100.00 |
| Cash | \$ 50.00 | |
| To B | | \$ 50.00 |
| Cash | \$200.00 | |
| To C | | \$200.00 |

and so on to the end of the month. Even if separate postings are not made of individual cash items, but the total of the cash column is posted to the debit of "cash" in the ledger at the end of the month, it is a manifest absurdity to duplicate every amount, when the total charge to "cash" can just as well be ascertained from the footing of the credit column. The debit column of "cash" can therefore be eliminated as useless, but it must always be remembered that it is still there in theory. Therefore, in posting from the left-hand page of the cash book, we are in reality posting from the right-hand column of a journal, and the seeming disappears. This is the reason that a cash book always has a heading on the left-hand page of "Dr. Cash." The journal entry used to be further indicated by the word "to" in front of every item on that page.

In the same way the total of the items on the right-hand page is a credit to "cash," in recognition of the right-hand journal column which has been eliminated as useless. This is expressed by the heading of the page "Cash, Cr.," and used to be further indicated by the word "by" in front of each item on that page, showing that the item was a debit. The use of the words "to" and "by" has been largely, if not wholly, discontinued, both in the cash book and ledger, as unnecessary. In posting from the right-hand page of the cash book, we are really posting from the left-hand column of that page. The use of the left-hand side of the journal and ledger for debits and the right-hand side for credits is a conventional custom for which no known reason has ever been given.

JOURNALIZING ALL ENTRIES

It is customary in some houses to bring all the business of the month into the journal by summaries, and to post everything that belongs in the general ledger from the journal entries. There does not seem to be any good reason for this, if the subsidiary books are kept in any reasonably proper manner. For instance, if the "purchase record" is kept on the plan of crediting each creditor with the goods bought from him such credits are posted directly from the record, and there does not seem to be any reason why the offsetting debits in the distributive columns should not be posted directly from the same book to the respective accounts in the general ledger. This is especially true of the practice some have of journalizing cash. To copy all these entries in the journal necessitates duplicating work, where a journal voucher is used, to triplicating it without any apparent advantage and with the risk of error in copying it. To say that it is well to assemble all the transactions in the journal is to lose sight of the fact that the cash book and all other books

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of original entry are themselves journals, and that all of these together are one journal, bound in separate covers merely as a matter of convenience, and with the journal idea somewhat obscure to the superficial observer, on account of the suppression in most of them of one or the other half of the journal entry—in its distinctive form—though it appears in reality when the totals are posted to the ledger.

OPENING DOUBLE-ENTRY BOOKS

When it is determined to transfer a set of accounts from single to double-entry system, it is necessary to make up a statement of the condition of the business by listing the assets and liabilities, the excess of the assets being the proprietor's net worth or capital. On the journal of the double-entry set an entry is made debiting the various asset accounts and crediting the capital account of the proprietor. Another entry is made crediting the liability accounts and debiting the proprietor. The balance of the proprietor's account will manifestly then be the difference between the assets and the liabilities. Or a compound journal entry may be made, in which the assets are debited on one side and the liabilities and proprietor's capital are credited on the other. The proprietor's capital is then shown as one amount credited, instead of the difference between a debit and a credit amount. Still, a third way is to debit the asset accounts and credit a balance account, and to debit the balance account and credit the liability accounts and the proprietor's capital. This last method is in favor among British accountants, but Americans as a rule do not see any advantage in opening a balance account and then immediately closing it again. If the single-entry cash book is of the regular pattern, it can be used for the new set. If the single-entry set included ledger accounts with customers and creditors, the same accounts may be continued. A number of general ledger accounts will have to be opened, one for each of the assets, except customers' balances, and for each of the liabilities, except creditors, and for the various elements which enter into the management of the business, such as "merchandise purchases," "sales," "salaries," "expenses," etc., the number of such accounts depending upon the extent to which it is desired to subdivide the information to be obtained from the books. The general, customers' and creditors' ledgers may be separate books, or subdivisions of one book.

DOUBLE-ENTRY BOOKS

The double-entry system usually covers the use of more books than the single-entry does. The only additional book that is essential is the journal. The books in which an entry first appears are called books of original entry, in which all items are entered in the order of the dates on which they originate. Ledgers are books into which these items are posted to the appropriate accounts. A ledger, therefore, is not a book

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of original entry, and for that reason it is not accepted by the courts as evidence, unless the person testifying states that he has verified the postings from the books of original entry, making it virtually his abstract of those books.

PROBLEM

The following problem is taken from the C. P. A. examination of May, 1913, in Illinois:

M. F. commenced business January 1, 1913, and early in February handed you his day-book with the following entries in it and requested you to open a set of double-entry books and submit a trial balance as of the close of business January, 31, 1913. Draft the trial balance.

| | | |
|--------|---|----------|
| Jan. 1 | Commenced business with cash capital | \$12,500 |
| 1 | Deposited in bank | 11,750 |
| 3 | Bought merchandise from Jas. Harrison & Co. ;.... | 2,700 |
| 3 | Sold goods to Wm. Adams | 2,400 |
| 7 | Bought merchandise from W. Smith & Co. | 3,225 |
| 8 | Paid wages in cash | 40 |
| 8 | Sold goods to H. Allan & Co. | 2,675 |
| 10 | Received check from Wm. Adams (discount \$60) | 2,340 |
| 10 | Bank deposit | 2,340 |
| 11 | Paid Jas. Harrison & Co. by check (discount \$135) | 2,565 |
| 12 | Paid by cash, three months rent | 200 |
| 13 | Bought merchandise from H. Kershaw | 3,700 |
| 15 | Paid wages in cash | 40 |
| 15 | Paid office expenses in cash | 35 |
| 17 | Sold goods to H. Hobson | 1,600 |
| 19 | Sold goods to Wm. Adams | 800 |
| 21 | Sold goods to H. Allan & Co. | 1,250 |
| 22 | Paid wages in cash | 40 |
| 22 | Paid expenses of office in cash | 25 |
| 25 | Paid W. Smith & Co. by check (discount \$160) | 3,065 |
| 26 | Received check from H. Allan & Co. (discount \$75) ... | 2,600 |
| 26 | Bank deposit | 2,600 |
| 29 | Paid wages in cash | 40 |
| 29 | Paid office expenses in cash | 20 |

There was \$175 cash on hand at the close of the month, the balance being M. F.'s personal expenditures.

SOLUTION

In order to find the condition on January 31 it is necessary to set up the following accounts: Since all the receipts were not deposited, and the bank balance at the end is not given it is necessary to charge and credit the bank in the cash book and to open an account with it on the ledger, in order to find the balance at the end of the month. The balance of the cash book will then be the currency on hand.

Students' Department

Cash Book

| 1913 | | 1913 | | | |
|------|------------------------|-----------------|------|-------------------------|-----------------|
| Jan. | 1 Investment | \$12,500 | Jan. | 1 Bank deposit | \$11,750 |
| | 10 Wm. Adams | 2,400 | | 8 Wages | 40 |
| | 11 Bank, Harrison ... | 2,565 | | 10 Discount, Adams .. | 60 |
| | Discount " | 135 | | Bank deposit | 2,340 |
| | 25 Bank, Smith | 3,065 | | 11 J. Harrison & Co. .. | 2,700 |
| | Discount " | 160 | | 12 Rent to March 31 .. | 200 |
| | 26 H. Allan & Co. | 2,675 | | 15 Wages | 40 |
| | | | | Office expenses | 35 |
| | | | | 22 Wages | 40 |
| | | | | Office expenses | 25 |
| | | | | 25 W. Smith & Co. ... | 3,225 |
| | | | | 26 Bank, deposit | 2,600 |
| | | | | Discount Allan & Co. | 75 |
| | | | | 29 Wages | 40 |
| | | | | Office expenses | 20 |
| | | | | M. F., Personal ... | 135 |
| | | | | Balance on hand | 175 |
| | | <u>\$23,500</u> | | | <u>\$23,500</u> |

Bank

| | | | |
|----------------------|-----------------|---------------------|-----------------|
| Jan. 1 Deposit | \$11,750 | Jan. 11 Check | \$ 2,565 |
| 10 " | 2,340 | 25 " | 3,065 |
| 26 " | 2,600 | 31 Balance | 11,060 |
| | <u>\$16,690</u> | | <u>\$16,690</u> |

Cash Discount Taken

| | |
|------------------------|--------|
| Jan. 11 Harrison | \$ 135 |
| 25 Smith | 160 |

Cash Discount Allowed

| | |
|---------------------|-------|
| Jan. 10 Adams | \$ 60 |
| 26 Allan | 75 |

Wages

| | |
|-------------------|-------|
| Jan. 8 Cash | \$ 40 |
| 15 " | 40 |
| 22 " | 40 |
| 29 " | 40 |

Office Expense

| | |
|--------------------|-------|
| Jan. 15 Cash | \$ 35 |
| 22 " | 25 |
| 29 " | 20 |

Rent

| | |
|--------------------|--------|
| Jan. 12 Cash | \$ 200 |
|--------------------|--------|

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Separate accounts might be set up for each customer and creditor, but the following method of treatment is equally clear and has the merit of saving time, which is an important point in an examination:

Amount Receivable

| | | | |
|----------------------------|-----------------|----------------------------|-----------------|
| Jan. 3 W. Adams | \$ 2,400 | Jan. 10 Cash & Discount .. | \$ 2,400 |
| Jan. 8 H. Allan & Co. | <u>\$ 2,675</u> | 26 Cash & Discount .. | <u>\$ 2,675</u> |
| Jan. 17 H. Hobson | <u>\$ 1,600</u> | | |
| 19 W. Adams | 800 | | |
| 21 H. Allan & Co. | 1,250 | | |

Accounts Payable

| | | | |
|-----------------------------|-----------------|----------------------------|-----------------|
| Jan. 11 Cash & Discount ... | \$ 2,700 | Jan. 3 J. Harrison & Co... | \$ 2,700 |
| 25 Cash & Discount ... | <u>\$ 3,225</u> | 7 W. Smith & Co. ... | <u>\$ 3,225</u> |
| | | 13 H. Kershaw | <u>\$ 3,700</u> |

Merchandise Purchases

| | |
|------------------------------|----------|
| Jan. 3 J. Harrison & Co. ... | \$ 2,700 |
| 7 W. Smith | 3,225 |
| 13 H. Kershaw | 3,700 |

Merchandise Sales

| | |
|------------------------|----------|
| Jan. 3 W. Adams | \$ 2,400 |
| 8 H. Allan & Co. | 2,675 |
| 17 H. Hobson | 1,600 |
| 19 W. Adams | 800 |
| 21 H. Allan & Co. | 1,250 |

As the books are not closed, all the above accounts are left open, the balance not being expressed, except the Cash and Bank, in which the balance is not self evident. The other accounts are supposed to be footed in small pencil figures.

Trial Balance, January 31, 1913

| | | |
|-----------------------------|--------|----------|
| M. F., Capital | | \$12,500 |
| M. F., Drawings | \$ 135 | |
| H. Kershaw | | 3,700 |
| Merchandise purchases | 9,625 | |
| Merchandise sales | | 8,725 |
| Cash in bank | 11,060 | |
| Cash on hand | 175 | |
| Discount taken | | 295 |
| Discount allowed | 135 | |
| H. Hobson | 1,600 | |
| W. Adams | 800 | |
| H. Allan & Co. | 1,250 | |
| Wages | 160 | |

Students' Department

| | | |
|----------------------|-----------------|-----------------|
| Office expense | 80 | |
| Rent | 200 | |
| | <u>\$25,220</u> | <u>\$25,220</u> |

Two accounts might be opened with rent, the original amount of \$200 being charged to "rent paid in advance," one-third of it being credited out by a charge to rent, but this hardly seems necessary. Of course, the year would appear at the head of every date column in practice.

The trial balance, used as a compound journal entry, would open the double-entry set. It seems useless to copy it again in strict journal form. If any examiner objects to this saving of time, or to any other portion of the solution, he will confer a favor by criticizing it. Persons taking the examination are often at a loss to know how much or how little they are expected to do. They do not want to waste valuable time, neither do they wish to leave out anything that the examiners would consider essential.

Book Department

MINES ACCOUNTING AND MANAGEMENT, By LAWRENCE D. DICKSEE, M. Com. F.C.A., Published by *Gee & Company*, London, 1914. Price \$1.75.

The preface states that the primary object of the book is to provide mining students with a handbook explaining how the actual transactions of mining should be carried on. Careful reading of the book, however, indicates that it is more specifically adapted for the perusal of accountants who are not familiar with the intricacies of mining or the details of labor pay rolls.

Chapter 1 concludes with a brief reference to the value of standard costs for comparative purposes. This all-important subject might well have been made the basis for an entire chapter. The office treatment of cash and bank accounts may follow an established English custom, but is not in keeping with current practice in American mines. One cannot but wonder whether the author assumes that the average mine manager does not comprehend the difference between "productive labor" and "overhead," or whether his accountant-readers needed primary instruction in the rudiments of double-entry bookkeeping. Also, it is not obvious why such specific directions should be given for handling the cash and cash accounts, if both chief and petty cashiers are to be employed, as indicated.

Chapter 4, on "wages," is ably and concisely written and highly instructive to any novice about to take up clerical work in a mine's office. The treatment of "stores accounts," or inventory, is incomplete. The author pleads for a frequent and accurate inventory, but overlooks a modern card-index perpetual inventory, almost universally in use wherever supplies are kept and issued. The system of requisition for supplies receives too little consideration, since the value of the material through this department frequently exceeds the amount of cash handled.

The chapter on "sales of output" is useless in America, because of the dissimilarity in mining practice, market, and treatment of ores. The author's differentiation between capital and revenue is warranted neither by economics nor custom, but the treatment of various methods of marking off depreciation, and his comparative ten-year table, showing the net depreciation by each method, are admirable.

Chapter 11, which discusses profit and loss, is really a general outline of corporate management. The latter one-fifth of the volume is a reprint of the Report of the Mine Account and Cost-Keeping committee of the council of the Institution of Mining and Metallurgy. This report is the most valuable portion of the book, comprising as it does a plea for uniform cost accounting in mines, wherever possible, and embodying the standard practice in the mines of the United Kingdom. The one possible field for this book is as a guide to accountants about to serve their apprenticeship at an English mine.

HENRY M. PAYNE.

Correspondence

Dignified Business

The Editor, The Journal of Accountancy:

Sir: Your editorial in the February issue entitled *Solicitation* and an article on *Ethics of Accountancy* in the March issue have been read by me. These are threadbare topics in nearly all professions, and, in the last analysis, the ethics of any profession are simply those governing what may be called the ethics of a gentleman. In matters pertaining to business, it is to be regretted that heretofore the rule rather than the exception has been "Every one for himself, and the Devil take the hindmost"—if I may be excused for using the colloquialism. Today, however, in both professional and business life, a higher standard of ethics is recognized to be in vogue.

In the profession of accountancy individual ability and experience are recognized as much as in any other and are the ultimate means by which success or failure is measured.

There are dignified ways in which the individual practitioner or firm may secure business, other than by display advertising or personal solicitation by employees, but I consider the solicitation by large incorporated companies, in which personality is entirely eliminated, derogatory to the profession.

I have before me such a letter bearing the names of prominent bankers as officers and also as members of board of control. Some of these men I have a personal acquaintance with and feel sure that if the matter were properly presented to them, they would not sanction the use of their names for such apparently ulterior motives or any profit they may gain. Is it not an infringement of the ethics of banking?

Respectfully,

H. R. ROBERTSON,

Minneapolis, March 23, 1914.

Announcements

The Ohio State Board of Accountancy

The Ohio State Board of Accountancy conducted an examination November 11, 12 and 13, 1913, with twenty-five applicants. Of this number the following passed the examination and received certificates: Messrs Robert E. Belt, Washington, D. C.; Robert H. Leamy, New York city; F. W. Hart, Cincinnati, O.; F. M. Schaeberle, New York city; Frank R. Wycoff, Cleveland, O.; A. L. Peters, Columbus, O.; F. C. Brubaker, Cleveland, O.; S. O. Watson, Cleveland, O.; J. D. Cloud, Cincinnati, O.; H. C. Marble, Cleveland, O.; and R. J. Beaman, Cincinnati, O.

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In addition, certificates were issued under the reciprocity clause of the Ohio statute to Messrs W. Valentine Manley, Chicago, Ill., and George Millar Barr, Pittsburg, Pa.

The firm of J. Lee Nicholson Company announce the removal of their office from 346 Broadway to the Woolworth Building, 233 Broadway, New York city.

Frank G. Du Bois, C. P. A., announces the removal of his office from the Union building to 1020 Kinney building, Newark, N. J.

Frederick J. Hillman, C. P. A., has been elected president of the Western New England Chamber of Commerce which is a federation of chambers of commerce and boards of trade in thirty-five cities and towns in Massachusetts, Connecticut, Vermont and New Hampshire.

We regret to record the death on March 9th of Andrew C. Feuss, C. P. A. (Maryland) a member of the Maryland Association of Certified Public Accountants and a fellow of the American Association of Public Accountants.

R. C. Lloyd has been appointed secretary of the Society of Louisiana Certified Public Accountants, in place of Paul Havener, resigned.

The accounting business conducted for many years under the name of Suffern & Son, certified public accountants, New York city, has been taken over by Messrs John R. Loomis, C. P. A., Edward L. Suffern, C. P. A. and Henry B. Fernald, C. P. A., and will be continued at 129 Broadway under the firm name of Loomis, Suffern and Fernald.

Frederick L. Thornton has resigned the position of assistant auditor of the Kansas City Electric Light company to become a member of the staff of Arthur Young & Co., certified public accountants, of Kansas City, Mo.

The Maine board of accountancy will hold its second examination in the early part of June, provided at least eight applications for examination are filed with the secretary not later than April 15.

William Dillon, C. P. A., announces that his office is now located at room 54, Mason building, 70 Kilby street, Boston, Mass.

Archibald W. Norman (chartered accountant) and Will B. Hadley (B. S. in Econ.) announce that they have formed a copartnership for the general practice of accounting under the firm name of Norman & Hadley with offices in the Land Title Building, Philadelphia, Pa.

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No. 5

Depreciation, Intangible Values and Rates

BY WILLARD HUBBARD LAWTON, C. P. A.

"The public, and many of the public's representatives, fail to recognize that in the final analysis, their interests and the interests of the proprietors of these utilities (the 'public' in great part being the proprietors) are inseparably involved one with the other."

(*Lecture Notes* by ALEX. C. HUMPHREYS,
President, Stevens Institute.)

The recognition of depreciation as a concrete, inescapable fact—not merely as a more or less interesting academic fad with accountants—has had a long struggle for existence in this country, but today the manager who still argues that as long as his plant is kept in good repair there is no depreciation is in a hopeless minority, and his friends are apt to pity him as a "hopeless case"! The conscientious accountant who has long tried in vain to induce managers and directors to allow him to provide for the inevitable day of replacement is coming into his own at last. Particularly is this so with public utilities. With the advent of public utility laws and commissions have come prescribed systems of uniform accounts, for the proper keeping of which corporation accounting officers are usually held responsible to the state. These systems include scientific classifications of revenues and expenses, and as the latter contain depreciation accounts with specific instructions for their proper use the question of providing for depreciation may be regarded as settled for public utilities. When we consider that it is but a few years since the average manager regarded de-

preciation as a joke, and the average director hardly knew the meaning of the word (except as applied to falling stocks), it is apparent that we have made progress. Laws usually reflect the prevailing thought of the period, and it is customary to condemn the average legislator for being less intelligent than his constituents; yet we must admit in this instance that the public service laws enacted during the past ten or fifteen years have shown enlightenment far beyond the general accounting knowledge of the times. True, here and there an echo of the dark days lingers in the laws: as late as 1913 the public service law of one state naively provides that on proper application to the commission a utility may be relieved of the requirement to keep a proper and reasonable depreciation account! As well apply for permission to ignore the force of gravity!

Reference to early debates and literature on these measures reveals, however, that the provision for depreciation was supposed somehow to deal a deadly blow to the soulless corporations. It was claimed that stockholders were drawing in dividends money that should be held in the treasury for future replacements, and that when the day of inevitable renewals came, it meant a new issue of securities for improvements, so-called, and the consumer was saddled with the burden of paying returns on the additional securities. Theoretically this is quite true. What was not clearly seen, however, was that while the system was vicious it carried its own punishment and remedy with it. In due time replacements had to be made but it was the investor who furnished the money for the new securities which he bought under the dear illusion that he was acquiring new property. As a matter of fact part of the new capital he thus contributed to the corporation merely made good the depreciation fund which should have been retained out of his past dividends. Because it did not so appear on the books did not alter the fact. But as a rule the consumer paid no more for his service than before, and frequently he paid less. In fact, the reckless ignoring of depreciation in the accounts has been equalled only by the fairly senseless reduction of rates which has been going on for many years. (We speak here of gas utilities in particular, but indirectly the same may be said of electric utilities perhaps.) Probably the reason there has not been serious embarrassment in these utilities heretofore is because of the great increase in

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service following reduction in rates, resulting in decreased unit-cost, which proves only that the plants have not been used to full capacity. There is a normal limit to such increase, however, and the statistics of public utilities as published annually by the commissions begin to show warning signs to the student of economics. Strange to say the very laws creating commissions to protect the oppressed (?) consumer, against which the utilities fought with frightened anger and gloomy predictions of ruin and disaster, are now likely to prove the financial salvation of those utilities.

Today commissions and courts acting on converging lines are gradually fixing limits to the net earnings of public utilities out of which may be paid interest on bonds and dividends on stock. By determining the "fair value" of the property used and useful in the public service the commissions are settling the question of the amount of the investment on which returns may be earned. The courts have practically settled that the investor is entitled to not less than a "fair return" on such investment, and commissions, accepting this principle, show a tendency to limit this return very strictly. On the other hand fixing the physical value (as included in the fair value) automatically determines within certain limits what should be the annual charge for depreciation, and since the price of the service must necessarily provide for this depreciation before fair return can be considered at all, the consumer learns that there is a minimum, as well as a maximum, rate involved, which may be succinctly represented by the formula

$$\text{Rate} = \text{Operating} + \text{Depreciation} + \text{Fair Return on Investment.}$$

I

None but the advocate of state or municipal ownership of public utilities denies the justice of a "fair return on investment," but the question "What is the investment?" involves the vast and complicated subject of valuation. Valuation covers two distinct fields — the tangible, or physical, and the intangible property. Physical valuation is simple in theory, though highly complex and detailed in practice. This field belongs to the engineer, and the accountant should not be called on (except

as a subordinate assistant) save in the rare case of finding a utility with a reasonably complete record of past construction. In the latter case his work will be to verify the disbursements for construction and equipment from the beginning, eliminating obvious replacements charged erroneously to construction, to apply theoretical rates of depreciation, checking them where possible by the actual experience of the utility, and to adjust his final conclusions with the appraisal made by the engineer. Discrepancies must be expected and as long as they are within reasonable limits the opinion of an experienced and competent engineer must be accepted as final. In the resulting tables of valuation the engineer will show a complete inventory of the utility's property (physical) with his appraised present values, while the accountant will show in parallel columns the original cost of each item and the difference, which will be the actual depreciation. If this last column does not agree with the theoretical depreciation assumed, it simply means that the latter is wrong as far as this particular utility is concerned. For the benefit of both professions at large both accountant and engineer should make careful notes of conditions which apparently give rise to such discrepancies and publish them in technical journals or before professional associations at the earliest convenient opportunity.

Unfortunately such a plain and simple method of valuation is seldom possible. Complete construction records are rarely available, and more often than not engineer and accountant are confronted with the task of valuing a plant where not even an approximately correct inventory exists. In such cases the work belongs practically to the engineer, the accountant, if employed at all, becoming purely subordinate to the former to assist him in making and checking calculations; and it is quite natural for the engineer to prefer to use his own staff. He, the engineer, must then make an inventory and appraisal of what he can find, and upon his data estimate what it would cost to reproduce the plant at the present day. From general knowledge and more or less hearsay testimony of past conditions he can usually make some estimate of the original probable cost of the units making up the plant, and the difference between this estimate and the appraised present value he calls the depreciation which is then deducted from the reproduction value to represent the present fair physical

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value. If he can make no reasonable estimate of such original value, he can at least make a fairly accurate guess at the age of the plant as a whole, and applying his table of depreciation to the reproduction value he obtains a theoretical present value, which may or may not be sustained by the appraised value, if any is made. As a matter of fact, in a gas utility at least, the appraisal method is of limited application, so much of the plant being underground. Where records of laying mains and services have been kept by dates, uncovering short stretches of pipe will give a fair idea of present condition, and where this can be done it is most desirable in order to have a check on present tables of theoretical depreciation which can by no means be considered as final. But if no such records are available it is clear that the present condition of a pipe laid at some unknown date in the past furnishes no clue to the amount or rate of depreciation. The usual procedure in such cases is to adopt the method known as "reproduction-less-depreciation," i.e. estimate what it would cost to reproduce the present plant as per inventory today and from that deduct the theoretical depreciation as shown by recognized engineering tables, a focal date for age being assumed from such information as the engineer may be able to obtain.

That this method is fallacious and somewhat dangerous must strike anyone who gives the matter fair consideration and study. It is fallacious because reproduction-new being compelled by lack of trustworthy records of the original costs and the conditions under which the plant was built must necessarily ignore such conditions; it is therefore equivalent to asking "What will it cost to build this plant under *present* conditions?" When we consider the increased cost of land, labor and most materials over that prevailing half a century ago, it is manifest that reproduction-new is bound to result in a value greatly exceeding the original cost of a long-established plant. This inequity toward the consumer is recognized by the commissions and to off-set it they propose to deduct from the reproduction-new value the estimated accrued depreciation to date. If proper depreciation funds have been provided in the past this would perhaps work substantial justice to all concerned, although it might result in many cases in higher rates for the consumer unless the old rates were abnormally high. But if former depreciation has not been accounted for, or has been inadequate, the resulting valuation

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may prove disastrous to the investor. It may be claimed plausibly that since the investor has had the benefit of his own sins of omission he should suffer the penalty. As an abstract proposition this may be so, but on the other hand we must consider two incontrovertible facts: (1) that if the plant is a long-established one and has been kept up to the latest standard of efficiency, then depreciation, not only of wear-and-tear but also of obsolescence and inadequacy has been made good through the repairs accounts, appropriations from surplus or by new capital—in any case made good by the investor; and (2) that the interests of the investor and the consumer are so inextricably involved that any injury to the one is sure to be shared in some form by the other.

Another fallacy is involved in the tendency on the part of commissions to adopt the method of applying an existing table of depreciation rates to all cases, because the method is easy and saves much time and labor to the overworked engineering staffs of the commissions. No reputable engineer will endorse such a method for his own plant and should not (as an "expert") for another's. If all utilities of a given class—gas, for instance—were in a general pool there would be some reason for using an average table for all plants; but since each company must shoulder its own operating burden, it is hardly necessary to characterize the rule that would attempt to apply fixed rates to widely varying conditions. The assumption of a focal date for convenience in applying the tables makes confusion worse confounded. A fair example of what this may lead to was shown in a recent valuation made as of July 1, 1913, with an assumed focal date as of 1884, in which gas service pipes were allowed a "life" of twenty-five years according to the table adopted. When some services were found to have been laid in or previous to 1884 and were still giving perfect service, the engineers had to solve the problem of the amount of depreciation to be fixed on pipes which had lasted more than five years after their tabulated "death"! (It was easy, however; they merely made another "assumption" that the pipes were renewed at the end of twenty-five years and accrued five years depreciation on the "renewed" pipes!)

Of course, the engineer who has been trained to use his common-sense with his technical knowledge would at once say that the only proper method of ascertaining depreciation in connection

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with reproduction-new valuation is to make a careful appraisal of the existing plant, and the difference between this and the reproduction-new of a similar plant might be considered a fair measure of depreciation. We say "might" but as a matter of fact neither value necessarily represents the "fair" value which all are trying to ascertain, that is of the physical property. The fair value of the plant lies somewhere between reproduction-new, which is probably too high, and present appraised value, which is too low, since it is clearly less than the original cost of the plant. Depreciation in a broad sense means lessening of value or worth, but in connection with valuations we must limit our conception of it strictly or we shall never get anywhere. It will not do to apply the "second-hand" theory to the physical value of a plant, particularly in a rate-fixing case. A plant having been used for a certain time is admittedly not worth as much as when first built as far as the physical elements are concerned; but it would be an error of the gravest kind to claim that the difference in these values constitutes depreciation as we contemplate it in a rate valuation. Depreciation in this narrow sense is the annual cost involved in the gradual wear-and-tear of the plant, combined with the contingencies of its becoming inadequate or obsolescent before it wears out entirely. While this annual cost is real and represents past and current disappearance of original capital, it has the paradoxical appearance of being an equalizing and prepaid cost to be actually incurred at some uncertain future date. This paradox, like all other paradoxes, is only apparent, as may be easily shown.

If all depreciation, *i.e.* destruction of original capital outlay, were made good only when required for efficient operating, it would show in the financial statements in the repairs accounts. These repair charges would be small at first but would increase in accelerating ratio till the time came when it would be more economical to replace the unit than to make any further repairs. If the accounts are kept consistently to the end the final replacement is also charged to the repairs accounts. This, it will be noted, makes depreciation synonymous with repairs from the accounting point of view, and it is strictly correct to term it thus, for, after all, repairs are nothing more or less than making good actual depreciation from time to time as it becomes apparent. But since the cost of the final replacement (ignoring for the

moment familiar cases where replacements in large plants of small units, such as meters, amount to comparatively regular and equal sums year by year) frequently is more than the total repairs on the unit prior to replacement, this method of taking care of depreciation through the repairs accounts creates a succession of violently fluctuating operating reports; for after a replacement there naturally follows a light season of repairs, and so on *ad infinitum*. Manifestly there is only one way to avoid this — by recognizing the fact that unobserved deterioration or destruction of original capital outlay is going on all the time which is not made good by ordinary repairs. This waste we call depreciation and make an annual charge based on the estimated "life" of the unit in order to create a reserve fund from which to draw the cost of the unit's replacement at the proper time. All of which is very elementary and the writer would feel like apologizing for inserting it at all, but for the experience he has had with those who confuse depreciation as a fact with depreciation as an accounting charge. Depreciation as a fact begins as a very small cost and increases rapidly toward the end of the unit-life. Depreciation as a charge is, or should be, an equalizer of this cost, spreading it over a term of years, the same amount being charged each year. In fact, we might well term the annual depreciation charge a unit-life insurance premium, since it works on exactly the same principle as life insurance, except that the rate for depreciation does not provide for the contingency of premature annihilation. This element, however, is covered by various forms of plant insurance, fire, boiler, cyclone, etc. A contingency it does not cover, though theoretically presumed so to do, is obsolescence, but the day may come when insurance underwriters may undertake even this protection. With enough plants insured to furnish a sufficiently broad basis there is no reason why this should not be possible, for all insurance is based on the law of averages.

The engineering profession has other names for these two forms of depreciation, *viz*: "actual depreciation," which corresponds to depreciation as a fact, and "theoretical depreciation," which is depreciation as an accounting charge. The latter is represented by tables similar to that shown on a following page, and it is the use of such tables which gives rise to another fallacy indulged in frequently by commissions in making valuations

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where no depreciation accounts have been kept. As stated before, if a proper and adequate depreciation account and fund has been kept and provided, no injustice is done to the investor by deducting accrued depreciation from the reproduction-new value, for the depreciation fund itself being assets "used and useful" in the public service, the utility will be permitted to include it in the "fair value" on which returns are to be earned. But if the utility has failed to provide for depreciation, while it is strict justice to deny it the right to include accrued depreciation (which it has never set aside) in its fair value, such denial should extend to actual depreciation only, not to theoretical. Because it is clear that since theoretical depreciation includes in the annual charge during at least two-thirds of the unit-life *more* than the actual cost of expired capital, *i.e.* actual depreciation, to deduct the total of theoretical depreciation amounts to depriving the utility of a large amount of value which has not yet disappeared.

Enough has been said to give a slight idea of the perplexing problems involved in the physical valuation of utilities alone, and when we add the very slight probability of any two engineers agreeing on the amount of reproduction-new, the wide discrepancy which usually prevails between such values and the amounts of outstanding securities, the confusion injected by countless mergers and leases of underlying companies, it is perhaps not at all surprising that the whole subject becomes so hazy and befogged with technical claims and assumed hypotheses that commissions and courts are driven to adopt all sorts of average and compromise valuations. That they do manage to deal out a rough sort of justice and equity at all is really a marvel.

II

While the accountant may stand aloof during the contest of engineers over physical values, he is speedily drawn into the fray when the question of intangible values comes to the front — and he sometimes retires in a humble frame of mind "a sadder and wiser man"! At the outset he must fight for the admission of such a thing as intangible value at all, for the consumer will vociferously maintain that intangible value is but another name for "water," and insist that physical value alone represents the

actual investment. On the other side the investor demands a return on the entire value of the property as a going concern which must in his opinion be at least as much as the total of outstanding securities and generally much more. It is between these two extremes that a wide field for study by economists and accountants lies, a field already strewn with wrecks of carefully built-up theories and hypotheses with fine-spun conclusions which have failed to impress the minds of commissions and courts. The latter, however, accept the principle of intangible values, but are still seeking firm ground for a scientific basis for them. Up to the present time such values have been quite arbitrarily assumed, usually being fixed at a percentage of the physical value ranging from fifteen to thirty-five per cent.

There are two classes of values which may be included in the term intangible, *viz*:

1. A value measured by actual expenditures from working capital for assets other than tangible; and
2. A value which accrues to a growing and successful business, for which no money has been actually expended, and which has more or less relation to its earning power.

Under the first class of intangible come

Preliminary expenditures,
Organization expenditures,
Franchise expenditures (paid to municipalities),
Legal expense during construction,
Interest during construction,
Taxes during construction,
Engineering and superintendence during construction,
Actual development expenses (paid out of capital funds);
Deficits during development period, including:
Discounts on securities,
Interest during period,
Unearned depreciation,
Unearned fair return (assumed) on capital invested,
Operating losses during period.

(For the sake of clearness it should be explained that "deficits during development period" does not necessarily mean the totals charged to the sub-items given, but the total net deficit shown after charging all against gross revenues.)

All the above are recognized as proper charges to pre-

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scribed capital accounts in the commission classifications, excepting actual development expenses and deficits during development. The latter must be charged to appropriate operating accounts or to suspense accounts pending amortization; but in valuation proceedings they are usually allowed to be proven as part of the intangible value, and presumably on final order of the commission they may be transferred in gross to a capital account, called "other intangible values," in a readjustment of the books. This is fair and reasonable as all the items, failing sufficient gross revenues, must be paid or set aside from working capital (except, of course, unearned return on capital). And since the state has assumed the right to limit the returns on capital, it must, by implication at least, allow the investor to claim as a capital loss the unearned return to which it is assumed he is entitled. Otherwise we shall have the unfair condition that the investor shall never be allowed to recoup himself for early losses; and it follows that capital will in future shun public utility investments where it cannot be assured of the limited return from the start — an unlikely condition.

Accountants will recognize an old friend in the second class of intangible values, which in private businesses is termed "goodwill" and is authoritatively recognized as a genuine property value. In a public utility which is usually a monopoly, the commissions and courts have declared there is no such thing as goodwill. Being promptly confronted with the undeniable fact that a successful public utility is certainly worth more than a less successful one, and even the latter is worth more than its "skin and bones," they have conceded an intangible value, which for a while was termed "franchise value." Many states have laid a tax on such franchise values with various methods employed to ascertain what it is. In time the enthusiastic manner in which many public utilities inflated the franchise value account led various state legislatures to restrict all claims for this value to the amounts actually paid to state or municipal authorities for franchise rights. As a rule these amounts have been infinitesimal compared with the actual value, over the physical, of successfully operated utilities, so the commissions and courts now recognize goodwill under the new name of "going concern value." As considerable confusion has arisen from the similarity of this name with "going value," it is advisable here to call at-

tention to the distinction. By "going value" is now generally meant the cost of getting the utility "going" profitably, and most engineers and accountants prefer to use the term "development expense" (as above) and it is properly included in intangible for which actual disbursements are made. It appears on the books in some account, and may be legitimately transferred to "other intangible assets" in a valuation.

"Going concern value" does not appear as a rule on the books, though it may be concealed in property accounts where two or more companies have been merged at inflated values. Occasionally it does appear in the form of a journal entry authorized by a board of directors, meaning that in the opinion of the board the corporation is worth that much more owing to certain new conditions which may have arisen since the original construction or acquisition of the corporation's tangible and other intangible assets. But as a rule "going concern value" represents on the one hand an attempt by the utility to justify the *apparent* over-issue of securities, and on the other an endeavor by commissions and courts to allow a fair value for the plant as a "going concern." In both cases, baldly stated, it is more or less an arbitrary attempt to fill or lessen the gap between valuations as found by actual appraisal and the amounts already set up on the books to represent property and plant, much of which is really replacement and should have been properly charged as such.

That there is such a thing as "going concern value" must be admitted. A successfully operated utility has a value over and above its physical and intangible value (of the first class). What that value should be based on, what relation it should bear to its net earnings or to other elements of value, whether it should appear on the books at all, whether it should be considered in all cases of valuation (for rate-making, taxation, condemnation, etc.) are decidedly puzzling questions for economists and commissions alike. It is a fairly settled policy in rate-making cases that going concern value must be allowed, and yet the logic of it is by no means as plain as could be wished; for the allowance of going concern value necessarily means the utility must have been operated successfully, and successful operation pre-supposes adequate rates — whose reasonableness is just what is being investigated. It would also seem logical to say that if a utility

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has been operated at a loss, there can be no going concern value, yet it is undoubtedly true that even though it is losing money now, it may make money later, and in any event the plant is worth more than it would be if shut down and dismantled. And further, if to development expense and early deficits is to be added a going concern value, it would clearly put a premium on bad judgment and mis-management.

In ascertaining intangible values of the first class, the accountant must verify all the charges to the accounts mentioned and be prepared to show the commission that the expenditures were reasonable, customary and tended to increase the business of the utility. He may find it necessary to make some adjustment in such accounts as interest, taxes and engineering, for the practice of commissions varies; in some cases these are regarded as "overhead charges" and distributed by the commission's men over physical property accounts on a percentage basis. When the accountant tackles the problem involved in the second class, he will have several theories to choose from, or may evolve one of his own. Unless he is prepared to give very convincing reasons for the latter, however, his best course will be to ascertain from former decisions the favored theory of the commission and follow that — the more enthusiastically the better!

Graphically the successive stages of growth of a utility to the point of showing a net income may be indicated by the following balance sheets:

END OF FIRST PERIOD — Organization.

| | |
|---------------------------|---------------|
| Cash (working capital) | Capital stock |
| Intangible: bond discount | Bonds. |

END OF SECOND PERIOD — Construction.

| | |
|---|---------------|
| Tangible: Cash (working capital) | Capital stock |
| Plant | Bonds |
| Intangible: Bond discount, organization, preliminary, franchise, legal, interest, taxes, engineering and superintendence. | |

END OF THIRD PERIOD — *Development.*

| | | |
|-------------|---|---|
| Tangible: | Plant | Capital stock |
| | Cash (working capital) | Bonds |
| Intangible: | Organization, etc. during construction as above; and deficit arising from excess of bond discounts, interest (during development period), operating (including development expense), depreciation and -% on investment over gross revenues. | Reserve for accrued depreciation Reserve for accrued amortization of bond discounts. |

The third, or developmental, period is assumed to end with the date when a profit is shown, but in making a valuation the method will be carried down to date of the valuation; so that if the financial history of the utility shows that during its whole existence it has earned more than the assumed rate of fair return, the intangible value derived from early deficits will, of course, disappear. This will leave intangible value as of the end of the second, or construction, period, omitting bond discount which becomes a suspense account to be amortized out of the fair return. To complete the valuation we must then add the "going concern value" as defined above.

Summarizing to this point we find as fairly well settled principles in rate-making valuations —

That the rate must be sufficient to pay the utility the cost of operating, adequate depreciation and a fair return on the investment, or fair present value;

That to obtain a basis for the annual depreciation charge, the cost of construction and equipment must be ascertained by one of two methods: (a) from records, if complete, and such cost to be compared with present appraised value to ascertain amount, and consequently rate, of depreciation; or (b) failing records, by estimating cost to produce the existing plant new and applying arbitrary tables of depreciation rates (known as "reproduction-new less depreciation" rule); and

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That to obtain the fair value on which the utility is to be allowed to earn the fair rate of return assumed, actual disbursements for intangible assets and an intangible value for "going concern" must be added to the physical value of the plant.

And since complete records are rarely found it may be added that as a general rule a valuation in a rate case means the reproduction-new less depreciation for physical plus whatever amount of intangible value the commission may see fit to allow. The rate of fair return is fixed more or less by the rate of interest prevailing in the section of the country in which the utility is located, it being the aim of the commission to fix such rate as will not deter capital from investment.

In effect, the commission says to the investor: "Having failed to keep your investment intact by setting aside the amount of accrued depreciation your property is worth just so much less than its cost (actual or theoretical), so in future you will be permitted to earn a fair return on that depreciated value only. You have had returns in the shape of dividends or interest to the extent of so much; the difference we allow you to capitalize in the form of intangible value."

To the consumer it says: "If the rate is higher than before it simply means you have been paying less for your service than it was actually worth. We do not compel you to pay back the difference, but in fairness to the investor we allow him to capitalize the loss of what he ought to have had, and in future you must pay him what the service is worth, i.e. the rate will be fixed at such amount as will pay him operating, depreciation and a fair return on the present fair value of his investment."

III

At first glance it would seem that such an adjustment in rates, increasing or decreasing them as the case might be, would be the correct and easy way to do justice and make everybody happy and contented. In reality it is not so simple a matter. Owing to the wide advertising given to the decisions in certain celebrated gas-rate cases (notably the Consolidated Gas Co. of New York and the Public Service Gas Company of New Jersey) the idea has become firmly fixed in the minds of the public that eighty-

cent, ninety-cent or dollar gas (like the nickel for a street-car ride) is fair and feasible for all gas utilities. This is true only in large cities or thickly-settled communities. An analysis of the 1912 report of the New Jersey board of public utility commissioners, covering the statistics of thirty-two gas utilities for the year 1911 (the latest report issued at this writing) reveals some interesting facts; and if the deductions therefrom which the writer has made are sound it would indicate that a general enforcement of the "adequate depreciation" clause of the state utility law, in connection with precedents as to methods of valuation already established by the commissioners, may have disagreeable surprises for the average New Jersey consumer outside the larger cities. As this report was the first attempt to collate statistics under the new law of 1911, it is well to bear in mind that it is not as complete in details as could be wished, and the figures must be considered with due caution. Also the writer would beg his confrères to remember the sage admonition of the genial doctor—"Logic is logic"!

While the commissioners have more than once stated that their decisions in the case of one utility must not be regarded as a precedent for another, they reserving the right to decide each case on its own merits and conditions, it is doubtful if they will be able to withstand in general the force of their own previous rulings. Given the same general conditions, similar decisions must result if the commissioners would escape the charge of discrimination. So if we apply to the other gas utilities of New Jersey the same reasoning and ratios applied to the Public Service Gas Company in the Passaic rate case, we have a fair right to assume that however local conditions may more or less modify these ratios in other cases in the future, the Passaic case has at least settled the general principles on which valuations and rates will be determined and fixed. The rate of annual depreciation can vary only within narrow limits unless the commissioners abandon the tables they have already adopted. Similarly the courts hold that a fair return on the investment must be permitted, so there is a limit below which the commissioners may not go—which in New Jersey may be considered six per cent at least. Since the rates for depreciation and fair return are thus practically fixed within narrow limits, there remains for fluctuation only the rate of fair value to book cost of property and

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plant. Undoubtedly this will vary widely according to the financial history of the utility, but this much is clear—the higher the physical valuation relatively to the whole, the greater will be the amounts required for depreciation and fair return; and *vice versa* the lower the physical value, the smaller will be the depreciation and return, but if the resulting fair value creates a deficit on the books of the utility, the latter is likely to starve to death for lack of new capital to make extensions.

The case of the Passaic division of the Public Service Gas Company was the first in which the New Jersey commissioners made a systematic and thorough attempt to ascertain the present (fair) value of the property of a gas utility used and useful in the service of the public. Most public accountants are probably aware that the commissioners and the company differed widely in their ideas of the values to be allowed, which in total were as follows:

| | Claimed by company | Allowed by commission | Ratio |
|---|-----------------------|--------------------------|-------|
| Physical: Reproduction-new less depreciation | \$5,818,940 | \$3,725,000 | 64 % |
| Intangible values | 3,090,551 | 1,025,000 | 33.2% |
| Total valuation | \$8,909,491 | \$4,750,000 | 53.3% |

The amount of physical value subject to depreciation was found by the commissioners to be \$3,038,055, or 34.1% of the *total* valuation claimed by the company; and the annual amount to be charged for depreciation was found to be \$81,397, or 2.68% of the depreciable physical value, straight-line basis.¹ The

¹ While the commissioners' report in the Passaic case shows (on page 63) that the straight-line depreciation is \$81,397, nevertheless they set an arbitrary rate of 6 cents per M.cu.ft. (producing about \$63,000 in 1911) as the annual amount to be charged for future depreciation. Their reason for so doing was stated (on page 64) to be because "analysis of the operating expenses of the company for the years 1904 to 1911 . . . indicates that minor renewals have already been charged to operating expenses." The logic of this may be correct as applied to *past* depreciation, but it is not at all clear as to *future*, particularly when we remember that the company is now keeping its accounts under the prescribed classification. Operating account No. 495, "General Amortization," provides:

"To this account shall be charged monthly or quarterly the amount estimated to be necessary to cover such wear and tear and obsolescence and inadequacy as have accrued during the period in the tangible gas capital of the corporation . . . less the amounts charged for that month to the various repair accounts.

In short, after finding that the straight-line depreciation is upward of \$80,000, the commissioners deliberately order the company to charge nearly \$20,000 less, and the repairs (or depreciation made good as shown heretofore) are to be deducted from that charge. Another fallacy is involved in basing the rate on gas production, for since pro-rating depreciation has in effect made it a fixed charge, there is no relation between it and the amount of gas sold. For instance, suppose the sales of the company should double those of 1911—the rate of 6 cents per M.cu.ft. would then produce \$126,000 where only \$81,397 would be necessary. Possibly the commissioners had such an idea in mind, and perhaps this will throw some light on the willingness of the company to accept the rate while it protested against the valuation.

price of gas per M.cu.ft. was reduced from \$1 net to ninety cents net, the commissioners affirming in their decision that this rate would cover operating, depreciation (at six cents per M.cu.ft.) and a fair return of 8% on the fair value (\$4,750,000). While the company has accepted and put in force the rate ordered, it has appealed to the courts from the commissioners' valuation. The lower court has sustained the commissioners, but the case is still pending in the highest court of New Jersey. Aside from the effect on the company's securities which the commissioners' valuation may have, it is obvious that the matter of valuation is of much more importance to the company and gas utilities in general than the question of present rates. If the court should hold that the commissioners' valuation is too low, it would follow that the prescribed rate is inadequate on the commissioners' own reasoning, *i.e.* that the rate must be sufficient to cover depreciation and a fair return as well as operating expense.

IV

The statistics in the report for 1912 give no information as to whether or not the operating expenses stated include any charge for depreciation, but it is pretty safe to assume as a rule they do not. Therefore, assuming that the fair and depreciable values of the property of each utility would bear the same ratio to book values as found by the commissioners in the Passaic case, and applying the rate of 2.68% for the annual depreciation charge,¹ we may see from table I following how the

¹ In a more recent valuation still pending the commissioners' engineers have worked out an average depreciation rate of 2.89%, but this has not yet been confirmed by the commissioners.

TABLE OF LIVES AND DEPRECIATION RATES

| Class | Life Years | Rate % |
|---|---------------|-----------|
| General structures | 75 | 1.33 |
| General equipment | 8 | 12.33 |
| Works and station structures | 70 | 1.44 |
| Holders | 50 | 2 |
| Boilers | 21 | 4.66 |
| Benches | 25 | 4 |
| Water gas sets | 29 | 3.5 |
| Purifying apparatus | 44 | 2.25 |
| Accessory equipment | 35 | 2.82 |
| Transmission and distribution mains | 41 | 2.41 |
| Services | 25 | 4 |
| Meters | 25 | 4 |
| Meter installation | 50 | 2 |
| Street lamps and fixtures | 20 | 5 |
| Construction tools | 20 | 5 |
| Laboratory equipment | 20 | 5 |
| Average life and rate on whole | 35 | 2.89 |

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other thirty-two gas utilities of the state would have fared had "adequate depreciation" been charged.

TABLE I

Showing earnings of thirty-two gas utilities on basis of depreciation charged.

| No. | Depreciable physical value on basis of Passaic case | Net gas revenues from 1912 report | Less depreciation on basis of Passaic case | Net gas revenues after depreciation | Fair value on basis of Passaic case | Rate of net after depreciation to fair value |
|-----|---|-----------------------------------|--|-------------------------------------|-------------------------------------|--|
| A | B | C | D | E | F | G |
| 1 | \$1,537,162 | \$265,665 | \$41,196 | \$224,469 | \$2,402,662 | 9.3% |
| 2 | 94,695 | 17,309 | 2,538 | 14,771 | 148,013 | 9.8% |
| 3 | 55,903 | 5,942 | 1,498 | 4,454 | 87,379 | 5.1% |
| 4 | 45,814 | 4,578 | 1,228 | 3,350 | 71,010 | 4.7% |
| 5 | 2,785 | 300 | 75 | 225 | 4,352 | 5.6% |
| 6 | 95,995 | 8,235 | 2,573 | 5,662 | 150,046 | 3.7% |
| 7 | 73,872 | 6,870 | 1,980 | 4,890 | 115,465 | 5.1% |
| 8 | 247,914 | 31,784 | 6,644 | 25,140 | 387,502 | 6.5% |
| 9 | 610,622 | 134,945 | 16,365 | 118,580 | 954,432 | 12.4% |
| 10 | 56,602 | 6,832 | 1,517 | 5,315 | 87,972 | 6. % |
| 11 | 160,790 | 8,746 | 4,309 | 4,437 | 251,322 | 1.8% |
| 12 | 406,990 | 186,960 | 10,907 | 176,053 | 636,146 | 27.8% ¹ |
| 13 | 15,142 | 2,557 | 406 | 2,151 | 23,667 | 9. % |
| 14 | 21,018 | 2,083 | 563 | 1,520 | 32,852 | 4.6% |
| 15 | 35,835 | 2,533 | 960 | 1,573 | 56,011 | 2.8% |
| 16 | 83,204 | 9,185 | 2,230 | 6,955 | 130,051 | 5.4% |
| 17 | 17,507 | 2,764 | 469 | 2,295 | 27,364 | 8.5% |
| 18 | 15,093 | 1,219 | 429 | 790 | 24,997 | 3.2% |
| 19 | 149,887 | 3,502 | 4,017 | - 515 | 234,281 | - .2% |
| 20 | 673,544 | 49,705 | 18,051 | 31,654 | 1,052,783 | 3. % |
| 21 | 68,529 | 543 | 1,836 | -1,293 | 107,115 | -1.2% |
| 22 | 23,246 | 3,237 | 623 | 2,614 | 36,335 | 7.3% |
| 23 | 70,286 | 14,893 | 1,884 | 13,009 | 109,860 | 11.8% |
| 24 | 32,390 | 6,945 | 868 | 6,077 | 50,628 | 11.9% |
| 25 | 54,181 | 5,165 | 1,452 | 3,713 | 84,688 | 4.2% |
| 26 | 34,025 | 7,789 | 912 | 6,877 | 53,183 | 13. % |
| 27 | 8,591 | - 640 | 230 | - 870 | 13,428 | -6.7% |
| 28 | 59,941 | 6,381 | 1,606 | 4,775 | 86,439 | 5.5% |
| 29 | 17,050 | 1,186 | 457 | 729 | 26,650 | 2.7% |
| 30 | 3,107 | 280 | 83 | 197 | 4,857 | 3.9% |
| 31 | 29,185 | 3,158 | 782 | 2,376 | 45,617 | 5.2% |
| 32 | 94,968 | 7,471 | 2,545 | 4,926 | 148,440 | 3.3% |

¹ Comparison with the others would indicate this company has been extremely conservative in its capital charges and possibly the amount stated in its report as cost of construction and equipment is purely physical value. In that case, allowing for the larger amount of annual depreciation charge, its net rate would be 18%.

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Summarizing table I shows that:

| 9 utilities would have earned over | | | | | 8 per cent on fair value | | | |
|------------------------------------|---|---|---|------------|--------------------------|---|---|---|
| 1 | " | " | " | " | 7-8 | " | " | " |
| 2 | " | " | " | " | 6-7 | " | " | " |
| 6 | " | " | " | " | 5-6 | " | " | " |
| 3 | " | " | " | " | 4-5 | " | " | " |
| 5 | " | " | " | " | 3-4 | " | " | " |
| 2 | " | " | " | " | 2-3 | " | " | " |
| 1 | " | " | " | " | 1-2 | " | " | " |
| 3 | " | " | " | lost money | | | | |

In short, 72% of the utilities would have earned less than 8% on the fair value of their properties, a return which the commissioners declared to be a fair one in the Passaic case. Even if the rate of fair return were reduced to 7% or 6%, the proportion is not greatly altered. Nor is there much to be hoped for in the contention that it is unfair to apply the ratio of 53.3% of total value to fair value for all the utilities — on the ground that the Passaic case might be an abnormal one — for the higher we make the fair value, the lower will be the rate of return; and while the ratio of 34.1% for depreciable value must admittedly be taken *cum grano salis*, since varying conditions of age, location, etc., make it impossible to fix any universal ratio of the kind between book and appraised values, two things must be conceded — that if the ratio is too low, the amount of depreciation must be larger with a higher one; and that it is hard to believe that the most drastic valuation can possibly reduce the depreciable value of any gas utility below 30% of the book value, save, of course, where portions of the plant have been destroyed or abandoned.

There is not much comfort in these figures for those who have been led to believe that the average gas plant in small communities is a gold-mine for its owners. Perhaps there will be still less for the consumer when table II, following, is considered. This table shows on the same basis as before what the rate to the consumer should be in order to comply with the conditions as to adequacy laid down by commissions and courts, i.e. that the rate must be sufficient to cover operating, depreciation and a fair return.

Showing Gas Revenues per M.Cu.Ft. Sold Required to Cover Operating Expense, Depreciation and 8% Return on Fair Value.

¹ Subject to note under table I.

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Summarizing table II we find:

| | Fair value | gas sold M.cu.ft | Average rate re- quired | Average rate re- ported | Average increase or decrease | |
|-------------------|-------------|---------------------|-------------------------------|-------------------------------|---------------------------------------|-------|
| 9 utilities (28%) | \$4,405,955 | 1,204,394 | .84 | 1.- | -.16 | 16. % |
| 23 " (72%) | 3,241,694 | 487,264 | 1.56 | 1.26 | .30 | 23.8% |

In detail the figures speak for themselves, though it is but proper to say that some of the utilities requiring the greatest increase in rates are of recent establishment and must have time to develop their territory.

Another point to be considered is that of the thirty-two utilities tabulated only five are receiving gas revenues of over \$1.50 per M.cu.ft. (and it will be noted that none of these earned over 8%), sixteen receive \$1.50 to \$1.25, nine, \$1.25 to \$1, and two less than \$1.

These figures show beyond question that dollar or ninety-cent gas is so dependent on consumption, or in other words on density of population, that those who clamor for a universal dollar, ninety-cent or eighty-cent rate for gas do not understand the conditions. They also show that even the promoters and owners of a majority of the gas utilities of New Jersey (and probably elsewhere) have taken much more desperate chances than they were probably aware of when they fixed the price of gas for their communities. If the Public Service Gas Company itself were obliged to earn operating, depreciation and an eight per cent return *in each community* in which it operates in proportion to its population, its rates would undoubtedly show the same inequalities as in the above table. It is a curious thing to remember that the commissioners, when they ordered the reduction rates in the Passaic division, also "recommended" that the company put the same rates into effect in all the rest of its territory. Since this company now serves about 70% of the entire population of the state, it would seem the only hope of state-wide 90c gas lies in allowing that company to absorb all the other gas utilities, and it would be quite logical for the commissioners to "recommend" it!

V

Paragraph (f), sub-section 17, section II, chapter 195, laws

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of 1911 of the state of New Jersey, commonly known as the "public utility law," reads as follows:

"17. The board shall have power, after hearing, upon notice, by order in writing, to require every public utility as herein defined; . . .
"(f) To carry, whenever in the judgment of the board it may be reasonably required for the protection of stockholders, bondholders or creditors, a proper and adequate depreciation account in accordance with such rules, regulations and forms of account as the board may prescribe. The board shall from time to time ascertain and determine, and by order in writing after hearing fix proper and adequate rates of depreciation of the property of each public utility, in accordance with such regulations or classifications, which rates shall be sufficient to provide the amounts required over and above the expense of maintenance to keep such property in a state of efficiency corresponding to the progress of the industry. Each public utility shall conform its depreciation accounts to the rates so ascertained, determined and fixed, and shall set aside the moneys so provided for out of earnings and carry the same in a depreciation fund. The income from investments of moneys in such fund shall likewise be carried in such fund. This fund shall not be expended otherwise than for depreciation, improvements, new constructions, extensions or additions to the property of such public utility."

It will be observed that the law is slightly conflicting in that whereas the general authority conferred by the heading of sub-section 17 is permissive and paragraph (f) begins by saying a proper and adequate depreciation account shall be carried "whenever in the *judgment* of the board it may be reasonably required for the protection of stockholders, etc.," the next sentence reads that it "*shall* from time to time" fix adequate rates of depreciation; and following this it is made mandatory on the utility to keep depreciation accounts and set aside funds accordingly. It is generally understood that the commissioners expect in due time (if the legislature provides the necessary funds) to comply with this law, which means, of course, a valuation of every public utility under its jurisdiction. But whether the board does so or not, it would seem competent under the law for any stockholder, bondholder or creditor of a public utility in New Jersey to call on the board to fix depreciation rates for his protection. It is not very likely that any consumer, although his interests are just as much involved as those of the investor or creditor, will make such a demand; but on the other hand when he makes a complaint of unreasonable rates the question of adequate depreciation must perforce be considered.

Taking the mandatory features of the section of the law just quoted in connection with the showing of table II, we begin to appreciate the dilemma, or series of dilemmas, confronting

commissioners, consumers and gas utilities — or perhaps it will bring the matter more closely home if we substitute "investor" for "utilities," as a generic name for stock and bond-holder. Because a corporation is a distinct entity in the eye of the law has always been sufficient ground for unreasonable attacks by the public, though perhaps with good reason in some cases; but we are beginning to realize dimly that corporations are made up of real, live individuals and directors are human beings acting in trust for other human beings. What is unjust and unreasonable toward the corporation is unjust and unreasonable toward the men and women who compose it.

The two horns of the dilemma confronting the commissioners may be stated as follows:

| | |
|---|---|
| If depreciation is enforced according to law, the price of gas to the consumer must be raised to allow its being charged. | If the price of gas is not raised, then depreciation cannot be enforced without confiscation. |
|---|---|

This dilemma applies, of course, only to the utilities whose rates are shown in table I to be insufficient to pay operation, depreciation and a fair return of 8%, but as shown they comprise 72% of the utilities of the state which supply gas, with nearly half the fair value of property used for the public service. On the other hand they serve probably less than 20% of the population. With respect to the other 18% there is no difficulty facing the commissioners. Reduction in rates is or will be popular with eighty per cent of the people of New Jersey, and the conclusion is obvious. Such reduction, moreover, is not only popular but from both legal and accounting points of view is strictly correct and proper (admitting that the state has the right to determine and fix fair rates of return on investments in monopolistic enterprises—a question which is not considered here). But what about the other twenty-three gas utilities? If depreciation is a fact to be recognized in one case, is it not in the other? If a fair return, whatever be the rate, is just and reasonable in one case, must it not be in the other?

Of course, it is an absurdity to question the fact of depreciation — there is no "if" about it. Depreciation begins with the first step in construction and continues with the inexorable, un-

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stayable progress of an Alaskan glacier. Dodge it as we may by refusing to account for it, the day of reckoning surely comes when the worn-out or obsolete unit must be replaced, and the money to pay for it must sooner or later come out of the price of the product. So if the commissioners should take refuge from the inevitable storm of wrath and denunciation following an unpopular increase in the price of gas in the case of the twenty-three gas utilities by taking advantage of the discretion granted in paragraph (f) and saying that a depreciation account is not reasonably required, they will merely postpone the evil day. In the meantime with such a ruling to justify them directors who regard only the letter of the law could declare dividends from merely apparent earnings till compelled to stop for lack of cash. But it is doubtful whether under a strict interpretation of paragraph (f) the commissioners could escape the responsibility once an action of any kind involving rates was begun, for having "ascertained and determined" adequate rates of depreciation. The law is mandatory that they "shall . . . fix" them, and the utility must then conform to them.

The economic effect of increasing the rates is another story and very complicated and interesting questions arise in the problems with which the investor must deal.

If depreciation is enforced but the rates are not raised where is the money coming from to pay it, to say nothing of a fair return?

If the rates are raised consumption will fall off, and the utility may be worse off than before.

And again, since fixing the rate of depreciation necessarily includes taking care of accumulated depreciation, either by scaling down book cost value or by setting up reserves, whether or not the price of gas is raised,

Decreased valuation of book cost of property means more or less impaired capital which must be made up by assessment or out of future earnings;

Or, if book value is retained and reserves are set up, the new liability must be offset by reserve funds to be accumulated out of future earnings.

As to the first dilemma, the commissioners may well take the

stand that the state does not undertake to guarantee a fair return and is not concerned with past errors in judgment on the part of the investor. As shown in table I most of the utilities would be able to meet depreciation, and if the commissioners insist on that alone they will be doing their full duty. In other words, the question of fair return can arise only where the utility is now earning *more* than what the commissioners consider fair. It is plain enough that otherwise the other horn of the dilemma will become acute. Take the case, for example (an extreme one, to be sure) of utility No. 21 in table II. Raising the rate to \$4.21 per M.cu.ft. would be farcical. The company would have to go out of business. But in general there is no reason to doubt that for a time at least many of the other utilities would experience a serious falling-off in consumption until the public became used to the idea of gas as a luxury. In time increasing population would warrant a decreased rate, which suggests the idea that the "Boston" plan of a sliding scale of rates related to net returns to the investor would be a solution of the problem worthy of study by all concerned.

When the second dilemma is considered it will be seen that it is inextricably involved with the first. True, the courts have held that consumers may not be called on to pay for losses due to past errors and bad judgment of the investor's managers, so new rates should not contain any element of such losses to be paid by future consumers. Such losses should fall entirely on the investor. But, as we have seen above, courts and commissions admit "early losses during development period" as an intangible value on which returns may be earned. In calculating such losses fairness requires the consideration of the entire past history of earnings on the basis of a rate sufficient to cover operating, depreciation and a fair return, the deficit of each year to be added as an intangible value. The question becomes one of determining the limit of the development period, and under the premises assumed that will be when the deficit turns into a surplus, if ever. Logically nothing remains for the state but to undertake to prove past errors and bad judgment — a difficult task at best. Failing to prove such errors and mismanagement as would penalize the investor, the commissioners must perforce allow a price that will cover a fair return on these accumulated deficits, which to that extent will compel the future consumer to

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pay for the losses of the past. Or else the doctrine of "early losses" as an intangible asset must be abandoned.

In either case the investor gets the worst of it. Abnormally high rates mean no business. Normal rates sufficient to get business mean low returns on the investment and consequent difficulty in obtaining new capital for extensions, etc. It is true that market value of securities will adjust itself to the income, but this will not help the utility in a state where new stock must be sold at par and new bonds at not less than 80% of par.

And what about the unhappy consumer? After he has waited through weary months of hearings at which he is completely obfuscated by incomprehensible claims and counter-claims of "going value, going concern value, service value, theoretical depreciation, actual depreciation, etc., etc." he finally faces a very simple dilemma, *viz.*:

If the present rate is insufficient to cover operating, depreciation and a fair return, it must be raised;

Or — no service!

The alternative may not come at once, to be sure. There may be a period of deteriorating service with consequent complaints, quarrels, appeals to the commissioners and orders impossible of execution for lack of money. There may be reorganizations temporarily tiding over difficulties, but this is an investor's remedy only, for it must be borne in mind that prices are based on appraised fair value, not issued capital. There may be a receivership with its usual waste and final ruin, followed by a new company which takes over the old plant, and so on *ad infinitum*. But the final result — to be escaped only by the one absolute requisite, *viz.*: adequate consumption to justify the lower rate — is abandonment of the enterprise by the investor. Then the only remedy left the consumer is state or municipal ownership, when general taxes may be drawn upon to make up operating deficits. Or, as already suggested, the Public Service Gas Company might take over all the gas utilities of the state, in which case we would have the amusing spectacle of a private monopoly being operated by two boards of directors, the superior one representing the consumer and the inferior, the investor. As this is practically the case with each individual

public utility today there would be nothing surprising about it. It would merely make more strikingly clear to those who have not yet grasped the idea that the difference between state regulation and state administration of public utilities is just as plain as the difference between Tweedledum and Tweedledee.

Whether this condition makes for better or worse is not material here. The conclusion that the condition exists is forced upon the writer through his actual experience with and his study of annual reports of state commissions. Rules and orders are issued freely which affect operations in every department of a public utility. No officer is safe in following the instructions of his board of directors without first making sure they do not conflict with some order of the commission. Since the law makes the commission's orders supreme, it is literally true, however unpalatable, that the state through its commission really administers the affairs of public utilities.

A few instances of such active control may be enlightening. A western commission has ordered the dismissal of a manager obnoxious to it; another is asking the legislature for power to compel the sale of utility securities by advertising for sealed bids; commissions have, or assume, the right to fix the price below which securities may not be sold; another commission has successfully maintained in court the right to ignore the terms of an existing franchise, and claims in general the right to void any franchise at its pleasure — a point, by the way, which has judicial sanction, the famous Dartmouth case to the contrary notwithstanding; and probably there is not a public utility in any "commission" state whose files do not contain letters from the commission "suggesting" or "recommending" changes in details of management or operation — "recommendations" which it is hardly necessary to say are followed with almost ludicrous alacrity. State regulation is merging insensibly and rapidly into state administration, as it is bound to do under the sweeping authority conferred by utility laws. So far have we advanced (or retrogressed?) from a government of laws to a government of men. The system is here as far as public utilities are concerned, and the signs of the time indicate it will be extended in due course to all human activities in the United States. So far it appears to have worked satisfactorily to the public. The only question is whether it will prove eventually to be like the cele-

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brated New Zealand labor system, which, it will be remembered, worked successfully to prevent strikes and labor troubles as long as wages were accommodatingly raised, but broke down sadly when hard times compelled a contrary course.

In conclusion it appears as if there is an interesting time approaching for the New Jersey commissioners as regards gas utilities, and perhaps for other state commissions as well. When the commissioners complete the valuation of all the gas utilities of the state of New Jersey, and as required by the law fix the rates of depreciation, there will doubtless be a general demand by the utilities affected for an increase in the rates to the consumer, based on the established principle that the price of gas should cover operating, depreciation and a fair return of 8% on fair value of the property. What with the natural exasperation of the investor because of the scaling down of the value of his property, and the unreasoning wrath of the consumer over the increased price of gas, the commissioners will be in a fair way to become generally unpopular — at least in thinly-settled districts. And yet what else can they do? Depreciation is a fact to be reckoned with and the law says it must be accounted for. The commissions have established the doctrine of "early losses" as an intangible asset to be included in fair value. The courts have upheld the right of the investor to a fair return, or at least, not less than a fair return, on the value. "The law doth give it; the court awards it." It seems like a case for the surgeon's knife. The operation may be painful while it lasts, but it will be best for the patient in the end — if he survives! In time weak utilities will be weeded out or absorbed by stronger neighbors. Public utility securities will be stabilized and retain their high rank as a most desirable form of permanent investment. Economically this result is much to be desired for every reason. It was bound to come sometime through the operation of economic laws, and on the whole it is better that the readjustment should come before the pressure for lower rates on one hand and the increasing cost of production and distribution on the other force the utilities into that most disastrous and wasteful method of readjustment — receiverships and foreclosures. That innocent investors and consumers must pay the cost of past blunders and financial errors, to call them no worse, is regrettable; but

that "the sins of the fathers shall be visited on the children" is no less true economically than morally and biologically.

The aboriginal Australian, when food supplies failed, used to abuse the shades of his fathers and spank their images, but beyond relieving his primitive feelings it did not remedy matters! Nor did it help much to end a drought for him to cut the throat of the missionary who was endeavoring to teach him civilized ways of making a living. "And the moral of that is," as the Queen says to Alice, that we public accountants when called in to help fight the commissions should endeavor to make our clients, whether investors or consumers, see the whole situation clearly, and urge fair and equitable adjustment rather than a fight to the finish. No fair-minded commissioner — and a study of commission reports and decisions will convince any open mind that commissioners are, as a rule, fair-minded — wants to drive a utility to the wall or impose onerous rates on a community. An agreement between the contending parties to a sliding-scale of rates that will eventually place the utility on a sound basis and give the consumer equitable rates is sure to be accepted gladly by the commission. Unfortunately, it must be confessed, it is the tendency at present for both parties to throw the entire burden and responsibility of what is usually a compromise decision on the commission after a bitter and rancorous fight. The result is that neither party is satisfied with the decision, however fair, and the commissioners are heartily damned by both sides. Failing, however, to induce his client to listen to reason, or if the other side prove obdurate, the accountant should be very careful to post his client's attorney thoroughly as to the tendency and bearing of the financial data he obtains from the books and which may come up in testimony. He should attend hearings regularly if possible; at all events he should insist on having a copy of the stenographic notes after each hearing. On the stand he should have no hesitation in fearlessly criticizing accounting errors and fallacies in theories advanced or apparently entertained by the commissioners or their assistants. Accounting theory and practice in public utility valuations are still in a state of flux, and every accountant owes to the profession and the state the duty of helping in even the humblest way to correct accounting heresies and to establish scientific methods.

Municipal Accounting, Reporting and Budget Making

BY WILLB. HADLEY

Municipal accounting, as we know it today, is of very recent development. So recent, in fact, that some of our text books dealing with the subject go no further than to describe the records of cash receipts, cash disbursements, debt and appropriation accounts that have been kept by national, state and municipal governments from time immemorial.

I was surprised, however, when recently I saw in the 1913 edition of an often referred to work the following reference to municipal accounting:

A municipal corporation's *principal asset* is its power of *confiscating the property* of its members and others within its limits, through taxation, to an extent which cannot be valued, but which is measured by the needs, as legally ascertained, of its members. In theory it is merely *an agent for converting property into service*.

As for Philadelphia's principal asset being its power of confiscating the property of its members and others within its limits, it would seem that a dollar tax rate for the entire city and county government, and a fifty cent tax rate for schools, can hardly be called confiscation in view of the many valuable services performed by it. And it does seem that assets aggregating \$296,994,223.77 at December 31, 1913, should not be overlooked in our system of municipal bookkeeping. These assets consist of \$16,187,039.54 of cash, \$4,466,617.80 of accounts receivable, \$610,652.07 of stores and postage, \$18,338,200.00 of sinking fund and fire insurance fund investments in our own city loans, \$29,401.00 of securities, and \$257,292,785.55 of land, structures, other improvements and equipment. The constant changes in the city's assets tell an ever interesting story to our citizens and officers.

The large capital outlays that all growing cities constantly have in contemplation make an analysis of the property account extremely important in forecasting what is best for the future

¹ Paper read before the Pennsylvania Institute of Certified Public Accountants at Philadelphia, March 20, 1914.

by the results of the past, just as in a private corporation before contemplated outlays would be authorized.

Of the \$5,224,926.38 of capital outlays in 1912 for property and equipment, \$1,190,602.00 was for land, \$3,619,438.76 was for structures and other improvements, and \$414,885.62 was for equipment and miscellaneous.

As to the municipality being an agent for converting property into service, is not this what the private corporation organized for service does? It furnishes service and in return it receives property, or, in other words "cash," as income. The nominal accounts "revenue (or income) accrued" and "expenses incurred" have as real a place and are as necessary to a proper understanding of operating results in a municipal corporation as in a private enterprise operated for profit.

Much the same haze and mystery has, until recently, surrounded municipal accounting as existed in the minds of many persons as to the organization, functions, methods and procedure of municipal government. Municipal accounting has been looked upon by many as a system of records foreign and apart from the accounting methods that apply to private undertakings, and some even went so far as to presume that a complete record of assets, liabilities, reserves, surplus, revenues accrued and expenses incurred currently kept was impossible of application to the affairs of municipal corporations.

City Controller Walton has applied to the accounts and finances of the city of Philadelphia, the accounting methods long recognized as essential to business success in the affairs of private corporations. As a result, the controller's office of the city and county of Philadelphia now has a general ledger that shows the financial condition of the general account, capital account, and special and trust accounts, and operating results as well as condition of funds in a few summary controlling accounts. Detail ledgers are kept for expense, revenue, permanent properties, taxes, water rents and other accounts receivable, funded debt, mortgages and ground rents, and vouchers audited and warrants payable.

Under the system of municipal and government accounting that obtained until recently, fund and appropriation accounts were very carefully developed, but proprietary accounting was almost lost sight of except for cash receipts, cash disbursements

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and debt. No double-entry system of bookkeeping existed that provided for taking upon the books currently all transactions of a proprietary nature, affecting assets, liabilities, reserves, surplus, revenues and expenses.

The problem of installing a modern accounting system for the city of Philadelphia was approached through the taking of an inventory of land, structures, other improvements and equipment, as of December 31, 1910, which inventory developed an asset the cost value of which was \$250,351,352. This was taken upon the new general ledger together with the cash, outstanding taxes, water rents, other accounts receivable, audited vouchers, warrants payable, funded debt, ground rents payable, mortgages payable, and surplus. A property ledger was started at the same time, which classified the lands, structures, other improvements and equipment by the department or bureau in whose custody they were, and by kind of property.

Forms are now being printed for another inventory of property and equipment that will be taken as of March 31, 1914, and returnable to the city controller as of May 1, 1914. In designing these forms a great deal of attention has been given to the question of reserves for capital depreciation and repairs. The plan is to get as careful engineering data as possible at the time of taking this inventory as to the proper annual percentage allowance for capital depreciation and for repairs. If future experience shows that the percentage figures require some adjustment, changes will be made from time to time. A fund of experience will be rapidly accumulated by the various operating departments and bureaus and by the city controller's office upon this subject. The interchange of these experiences will make possible the rapid development of highly accurate percentages for capital depreciation and reserves for repairs for all the many kinds of buildings and other structures, non-structural improvements and equipment of the city and county of Philadelphia.

An analysis of expenditures as of the time the vouchers are audited which was begun January 1, 1911, furnished a current distribution of expenditures that segregated capital outlay from current expenses, and general fund expenditures from loan fund expenditures. The general ledger proprietary accounts were segregated as to general account, capital account,

and special and trust accounts. The general ledger fund accounts were analyzed as to general fund, loan funds, and special and trust funds. The segregation of expenditures as to current or running expenses and capital outlay, and as to general fund and loan funds, makes it possible to know currently the amount of revenue money used for capital outlay and the amount of loan moneys used for current expenses and, consequently, for each accounting period the net use of loan moneys for expenses, or revenue moneys for permanent improvements, as the case may be.

Expenditures are also analyzed by objects, in order to conform to a requirement of law that city councils must appropriate specifically by objects. It has been found as a matter of practice that such an analysis is used a great deal owing to the fact that members of councils, officials and citizens think constantly in terms of objects of expenditures, *i.e.*, salaries and wages, printing, subsistence, materials, supplies, etc.

Expenses incurred of the city and county of Philadelphia are now being classified by organization unit, function, character, and object. The organization unit makes it possible to show the expense incurred by each department or bureau; and by comparing one period with another relative costs are obtained.

The analysis of expenses by function has proven exceptionally valuable, for the reason that new functions are constantly being added to municipal government, and oftentimes increases in expenses are due almost entirely or wholly to such additions rather than to increased cost of older functions.

Analysis of expenses by character shows whether the expense is for administration, operation, maintenance, or fixed charges. The character analysis also shows expenditures for capital outlay.

The analysis of expenditures by organization unit, function, character, and object is made at the one time by means of punching holes in cards with a key punch. The cards are subsequently sorted and tabulated by electrical machines.

After City Controller Walton had firmly established the new system of asset and liability, revenue, expense and fund accounting in the controller's office, he extended it to the various departments and bureaus as of January 1, 1913, by publishing in December, 1912, a series of forms, known as the *Blue Book*

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of Forms, which set forth for each department and bureau standard documents, standard registers and schedules of documents, standard detail ledgers and standard monthly reports (or schedules of totals and balances) for the various detail ledgers.

A year later (which brings us very nearly down to date) City Controller Walton published his *Manual of Accounting, Reporting and Business Procedure of the City and County of Philadelphia*. This manual became effective January 1, 1914. It states in detail the procedure to be followed with the various kinds of documents, as well as the methods of registering and scheduling documents. The schedules are carbon copies of the registers and come to the controller's office currently, where they are audited and recapitulated. It also sets forth the various detail ledgers to be kept, and the general ledger and general journal procedure together with the various standard monthly general journal entries.

The manual requires the departments and bureaus to send to the controller's office standard monthly reports, which are schedules of totals and balances drawn from each detail ledger. These reports, when filed in the controller's office in loose leaf binders, make detail ledgers of revenue, expense, property, etc., for the city as a whole.

The schedules of documents which are sent to the city controller's office by each department and bureau are placed in loose leaf binders. Summary monthly totals are taken of the schedules of each kind of documents. These totals are the basis of the monthly journal entries for the city controller's general journal.

The general ledger in the controller's office produces monthly summary balance sheets and operation accounts. It further controls through its accounts the various detail ledgers. It makes it possible to place upon the controller's desk each month summary balance sheets and operation accounts on regular printed forms. The general ledger procedure in the city controller's office has been developed to such an extent that standard printed monthly journal entries are now used.

One of the most important elements of value of the new accounting system is its segregation of the general account; the capital account, including permanent funds, properties and improvements, and sinking funds, and the special and trust ac-

counts in the proprietary group; and the general fund, loan funds, and special and trust funds in the fund group.

The information thus developed, as well as the power for action which it gives, is most interesting. It makes possible a scope of procedure over the whole field of finance which was impossible with fragmentary accounts and reports, and places within the controller's reach a wealth of exact information relating to the city's financial condition, the operating results that are being secured, and the funding provisions made for the city's future needs. It is only through such comprehensive and current information that the city controller can fulfill under modern conditions the exacting requirements of his office. He has emphasized most strongly in all his work the reporting phase of municipal accounting. In the modern sense, accounts are of little value unless they produce reports currently, promptly and accurately that tell in a summary way financial condition and operating results of each item of the summary statement adequately supported by the schedules of totals and balances from detail ledgers.

One of the results of the installation of the new accounting system is a pending readjustment in the general account payments to the sinking fund account of over four hundred thousand dollars a year.

So much for the purely accounting side of this subject. I now wish to show how funds become available for appropriation, and to outline our budget making procedure. The principal distinction between municipal accounting, as we know it today, with its system of proprietary accounts, *i.e.*, assets, liabilities, reserves, surplus, revenues and expenses fully developed, and the accounting of private enterprises is the high development of the fund and appropriation accounting of the former. Large private companies have recently given considerable attention to fund accounting, particularly in the matter of capital outlays, but nowhere has it been worked out as in municipal and government accounting. There it was developed very early under explicit provisions of law as a means of insuring the expenditure of public moneys in accordance with the wishes and desires of the people as expressed through their duly elected representatives. The instrument of fund accounting which we recently have been hearing so much about, and which has been very greatly

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developed and expanded, but which in its inception goes back a great many years, is the budget.

Funds that become available for appropriation by city councils for city and county purposes are divided into three main classes, *vis.*: general funds, loan funds and special and trust funds.

General funds are secured through the medium of the city controller's legal estimate of receipts which he makes annually to city councils in November. In addition to this annual estimate there is usually a fund surplus available at the closing of the year's books, arising from an excess of actual receipts over the estimated receipts and from merging balances of appropriations. These are the only sources from which general funds may be secured for appropriation, with the exception that city councils may authorize a temporary loan not exceeding \$1,200,000, redeemable in four months.

The amount of loan funds available for appropriation at any time depends upon the borrowing capacity of the city. In arriving at the borrowing capacity the first step is to determine the debt limit. The state constitution of 1874 limits the city's debt to 7 per cent of its assessable property. Prior to the act of June 17, 1913, the borrowing capacity of the city was based almost entirely upon the assessable value of real estate—only about \$2,000,000 of personal property, horses and cattle and carriages to hire being taxed for city and county purposes. This act of legislature, however, made money at interest taxable for city and county purposes, thereby increasing the borrowing capacity slightly over \$40,000,000. The act of July 21, 1913, restricts the borrowing capacity based upon personal property to "transit facilities and other permanent improvements," so that we now have a debt limit for general purposes based upon the assessable value of real property, and a debt limit for special purposes, such as transit facilities and other permanent improvements, based upon the assessable value of personal property.

The net funded debt is determined by deducting from the gross funded debt the par value of city loans held by the commissioners of the sinking fund and the net city debt outstanding for school purposes. To the net funded debt are added mortgages and ground rents outstanding. The total debt thus obtained, when deducted from the debt limit, gives the amount

of loans that the city can issue or, in other words, its borrowing capacity. In determining what further loans can be authorized, however, the total of loans authorized and unissued is deducted from the borrowing capacity.

It is thus seen that the amount of loan funds that becomes available for appropriation each year depends upon the increase in the assessed valuation of taxable property, upon changes in the gross amount of funded debt outstanding, upon the increase in the amount of city loans held as investments by the commissioners of the sinking fund, upon the decrease in the net school debt outstanding, and upon any changes in the mortgages or ground rents outstanding.

Special and trust funds become available for appropriation through the receipt of money by the city treasury for special and trust purposes. This money is kept in the city treasury in special funds, and is appropriated by city councils for the specific purposes for which it was received.

Having seen how city councils are provided with funds for appropriation, general, loan and special and trust, the question naturally arises in the minds of many people as to the machinery for supplying city councils with accurate and complete information upon which they can pass intelligent judgment as to the departments and bureaus to which they shall appropriate money, for what functions or activities it shall be appropriated, as to the character of the expenditure, whether it shall be appropriated for administration, operation, maintenance, debt service or other expense, or for capital outlays that later shall pay satisfactory returns to the city through making possible large economies in operation and maintenance. Further than this, city councils must know the objects of expenditure for which they appropriate funds, because an act of legislature specifically requires that no appropriation shall be made of the moneys of the city without an ordinance therefor, expressing the objects thereof and the amount appropriated for each object.

The procedure by which this information is obtained for city councils is known as the preparation of the budget. The departments and bureaus prepare upon printed forms, issued by the city controller each year, their estimated requirements for the new year. These forms are so prepared that the estimates may be classified as indicated above. The estimates as originally

Municipal Accounting, Reporting and Budget Making

prepared are subject to numerous revisions, first in the respective bureaus, then in the directors' offices, and, finally, in conferences between the mayor and his directors. When satisfactory to the mayor they are forwarded to the city controller.

The estimates of the various county departments and offices are forwarded at about the same time as city departmental estimates to the city controller. The latter recapitulates the estimates of the city and county departments and submits such recapitulation, together with his legal estimate of receipts and the detailed departmental estimates, to city councils, who then fix the tax rate and make appropriations for the new year.

In addition to the annual general fund budget estimates, further estimates covering contemplated permanent improvements are made by the various departments and bureaus and submitted to city councils from time to time. The latter in their discretion prepare loan ordinances to meet these requirements.

Ethics

BY WILLIAM WHITFIELD, C. P. A.

The "science of human duty," as it applies to the accounting profession, is a matter of far reaching consequence and merits serious consideration by those who would secure—in their dealings with their clients, their contemporaries, and the public—that degree of respect and profit which is derived only from the pursuance of high ideals, the practice of honest principles, the performance of efficient and valuable service and the recognition of these merits by others as well as by themselves.

With the profession of accountancy, unique in its infancy and its importance to financial and commercial interests, it is to be hoped that continuous discussions of its ethics may result, not only to serve as markers of the progress of the vocation but also to aid in its development. Such usages as are now observed must necessarily be multiplied from time to time by additional duties assumed—and to some extent thrust upon the members of the profession—as logical obligations or for enhancing the value of services rendered.

It would not be rational to suppose that new ethics would be adopted generally except as being of benefit, nor would it seem wise for individual members to ignore those principles and practices which have stood the test of time, and being of proven merit, are in favor with the majority. Furthermore, the accountant should study the expectations of his clients and the public as to the dignities and responsibilities to be observed, and as far as possible should anticipate such expectations. At no time should the logical responsibilities of the profession be in any way evaded or shirked; such action would result in disparagement, not only to the work of the individual but to accountancy in general.

To achieve the largest results there must be a willingness to assimilate the most advanced usages not only of this, but, as may be applicable, of all other professions. By this means accountancy will attain its rightful position as a prime factor in the business world, as relates to its organization, efficiency and advancement.

Ethics

The main underlying principle of ethics is the engendering of a feeling of confidence in the accountant—both as to his moral integrity and his ability—in every possible direction; this should be encouraged, as its dissemination can never be too great. Only comparatively insignificant and profitless work can be secured by the accountant who cannot command confidence.

In the line of securing business it can seldom be considered that advertising is a policy that encourages confidence. The efficiency of the accountant cannot thereby be accurately gauged, and it may develop in the mind of the public the idea of lack of patronage or failure to secure a full appreciation of service from such as have had dealings with him.

It also carries the impression that accountancy is a mere merchantable chattel, of more or less standard quality, which may account for some of the requests made of accountants for competitive bids. Such an impression at once destroys the personal equation factor, the greatest asset of all professions. The weighing of one accountant against another on a cost, rather than on a merit, basis will result too often in dissatisfaction to both client and accountant. It would seem that advertising redounds to the benefit, in many cases, not of the accountant who incurs the expense, but rather of others. To a limited extent it may create an interest in, and perhaps a discussion of, accountancy, which results in the prospective client referring to an accountant with whom he may be familiar, or to making inquiries of his bankers or other business acquaintances.

The greatest source of business should be clients for whom service has already been rendered. Failure in this respect is the most conclusive evidence of inefficiency. Recurring service for, and recommendation by, former clients, is the supreme test of accounting success.

General solicitation of business by accountants is a material factor in lowering the profession in the estimation of the public. It indicates a desire to get work of any kind and at any price; it necessarily places the accountant, if engaged, in the position of a subordinate and beholden to his employer, rather than in the position of a disinterested specialist, to some extent dictatorial.

The cutting of rates on the part of an accountant, with the knowledge of the client, cannot fail to diminish the prospect of

establishing confidence, nor to undermine such feeling of trust as may already exist. It curtails the just profits to which the accountant believes he is entitled in establishing rates, it betrays a weakness in not adhering to the scale adopted, and doubtless lessens his own self respect. The accountant who, upon learning the nature of prospective work, states his *per diem* rates definitely, immediately lays his first foundation stone to respect.

The attempt to divert business already held by another accountant is reprehensible from all standpoints; in the legal profession it has been considered a just cause for disbarment, so injurious is its effect.

The relations and dealings with the client should be most confidential, his affairs buried in the utmost secrecy. In the performance of the duties of the profession an obligation exists to make of the service an exact science, tolerating no undue prejudices, and always keeping in mind the unknown numbers who are compelled to base their opinions on such information as the accountants, as independent and responsible persons, furnish.

Since it is a fact that clients usually prefer their accountants to be men of good standing among their fellow accountants, it is desirable that a strict observance of ethics be followed; by such means, embracing a unity of thought and action by accountants, will the profession be advanced and upheld as one of which we may be proud, and through which we may be plenteously rewarded.

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EDITORIAL

Corporations and the Common People

It is a thousand pities that the ordinary man of ordinary means, who in the aggregate is designated "the common people," has not considered the logical result of the campaign of "trust-busting" which has spread over the country during the past few years. It sounds very well to decry and defame railroads, industrial corporations and the like; and it generally carries with it a certain amount of prestige among critics at the corner grocery. Unfortunately the effect of this sort of tirade is not confined solely to that ancient seat of political criticism, but the orator may find a ready audience in places where it might reasonably be expected that a higher degree of wisdom would prevail.

So long as the idea of attacking the railroads and industrial corporations is restricted to abstract discussion there may be no valid objection to it. There comes a time, however—and unfortunately that time has come—when this insensate attack reaches the point where it will do vast harm. When the legislators of state and nation are imbued with the idea that every combination of capital or enterprise is a menace to the public weal, the welfare of the country is seriously imperilled; and when the

conception comes to birth no one knows what irreparable damage may be wrought.

It is difficult to understand how any nation can tolerate for a moment a propaganda which has for its avowed object the destruction of corporate enterprise; and yet in this land with its one hundred million people, there is probably a great majority which would express itself against any sort of corporate endeavor as opposed to individual effort.

Let us look for a moment, however, at the inevitable outcome of any course of action leading to the destruction of reasonable combinations of interests. If we study this matter carefully we shall find that the man in the street, the man in the club, in fact nearly every voter at the polls has a vital and personal interest in the maintenance and integrity of corporate enterprise. This is not an affair solely concerning the rich or even the moderately well-to-do. It affects directly every man who has a dollar on deposit in a savings bank and every man who has set aside a portion of his income for the protection of his family in the event of his death. It has been estimated that the savings banks and insurance companies of the country have approximately two billions of dollars invested in railroad and industrial bonds. It has also been estimated that approximately twenty million people are interested in the stability of these two kinds of fiduciary institutions. Every man who has a savings bank account or an insurance policy is affected by the condition of the bonds of railroads or industrial concerns.

For a long time it has been a favorite pastime to attack railroads and other corporations in the belief that they were amassing enormous sums of money at the expense of the common people. It has been asserted time and again that the railway rates are too high or that the cost of necessary commodities is excessive, and it has been easy to point to the stupendous fortunes which have been accumulated by a few individual men; but the truth of the matter is that every man in the country, be he rich or poor, has an interest personal and intimate in the upbuilding of great commercial undertakings and in the maintenance of this country's prosperity. It seems as though some strange hallucination had overspread the country. Every stump-orator finds that he has only to utter the most absurd denunciations against the corporations in order to obtain the ear of the

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multitude and the applause of the unthinking. Yet if there were no corporations the condition of the country would be deplorable and every man in it would find himself in an infinitely worse position than that in which he stands today.

It is admitted frankly that there should be and must be some control of the activities of railroad and other corporations. There should be the strictest supervision of the issuance of securities; the mad financing of former years must be avoided in the future; but the way to prevent wild-cat schemes and the consequent defrauding of the public is not by a wholesale condemnation of every corporate enterprise, but rather by a wise discrimination between methods worthy and unworthy. Already it is possible to discern a slight revulsion of feeling against the theory that all corporations are a fit butt of attack. People are beginning to wonder whether or not it is wise to deprive every corporation of every means of livelihood. The condition of the stockmarket, the steady decline of bond values, the obvious decrease in the country's purchasing power—shown by the recent trade returns—all these and other things are having effect and it seems as though the public itself (which has been so vociferous in its demand for the strangulation of the so-called trusts) were beginning to see there may be combinations of capital which are for the good of the nation at large. This feeling no doubt will spread and sooner or later will be heard in no mistakable manner at the polling booths; but the one point (which although most important seems to have been entirely overlooked) is that every one of us has a direct interest in combating anything which makes for the restriction of corporate activity within too narrow limits.

It is the proud boast of the United States that its volume of savings deposits is the greatest in the world. The phenomenal growth of our great insurance companies has been another source of pride. In order to protect the funds of the people invested in these two classes of institutions, state legislatures have specified the media of investment permissible, and a great portion of the funds of both has been invested in railroad and, in many states, in industrial bonds. Yet we find these same legislatures and these same people whose funds are concerned clamoring for destruction of the very corporations upon whose securities so much depends. It is a strange anomaly and when the chronicle

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of this time comes to be written the historians will find it difficult to reconcile or to explain the extraordinary contradiction.

It may be argued that the just way to convince the public of the un wisdom of so persistent an attack against legitimate enterprise is to allow nature to take its course, but we believe that there is a better way.

There should be an effort to educate the public before worse harm is done, and by every sign and token the time for educative effort is here.

The Students' Department

On another page of this number of *THE JOURNAL OF ACCOUNTANCY* will be found the fifth instalment of the *Students' Department* under the able editorship of Mr. Seymour Walton. When the department was begun in the January issue we congratulated our readers and ourselves upon the good fortune of obtaining Mr. Walton's assistance. The result more than justifies that congratulation. From all parts of the country we are receiving letters of commendation and the department bids fair to become what it was intended to be, namely, the last word in accountancy education for the aspirant to C. P. A. honors.

One point, however, should be impressed upon the readers of *THE JOURNAL*. The *Students' Department* is not intended to be solely an *ex cathedra* statement. It is desired that it should be a forum for the discussion of accountancy with a particular bearing upon the problems and difficulties which confront the student. In order to be this it is necessary that students and others should feel free to write to *THE JOURNAL*, asking questions which occur to them and making suggestions which may be of value to others who are in search of accounting knowledge. Therefore, we cordially invite correspondence and are confident that the editor of the *Students' Department* will find it a pleasure to reply to questions asked and to render assistance to those who are in need of it.

Against Departmental Reforms

At the end of the urgent deficiency bill recently enacted by the congress of the United States appears the following interesting and instructive section :

"Sec. 4. That no part of any money appropriated in this or any other act shall be used for compensation or payment of expenses of accountants or other experts in inaugurating new or changing old methods of transacting the business of the United States or the District of Columbia unless authority for employment of such services or payment of such expenses is stated in specific terms in the act making provision therefor and the rate of compensation for such services or expenses is specifically fixed therein, or be used for compensation of or expenses for persons, aiding or assisting such accountants or other experts unless the rate of compensation of or expenses for such assistants is fixed by officers or employees of the United States or District of Columbia having authority to do so, and such rates of compensation or expenses so fixed shall be paid only to the person so employed."

It is impossible for the ordinary layman of moderate mentality to ascertain exactly what congress had in view when it decided to enact so remarkable a provision. Representatives of the American Association of Public Accountants took the trouble to go down to Washington and point out to some of the members of both houses the fallacy of such a law and the effect which it would have upon the employment of expert accountants, but so far as can be discovered there was no valid argument in favor of the proposition except a certain deep-seated and apparently ineradicable fear that someone would be overpaid. We all know that such a thing has never been known to happen on Capitol Hill, therefore anything which would savor of special interest or monopoly or of any of the other hobgoblins which are used to frighten a timorous public must be prevented at all hazards—but, to be quite frank we think that the gentlemen who are responsible for the regulation somewhat misunderstand conditions.

For a long time it has been the effort of accountants to do away with the old practice of a flat contract rate for accounting services, laboring under the impression that it is infinitely better for the man who buys services to pay for exactly what he receives rather than to pay a lump sum which may be too little or too much (and it may be said in passing that contracts are not apt to err on the side of underestimation).

The case was well presented by the president of the Ameri-

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can Association in a brief submitted to the committee on appropriations of the United States senate, and in view of the importance of the question at issue we append the full text of the brief.

There seems to be little to add to the arguments adduced by Mr. Montgomery. Since his brief was presented the bill has become law and for the present at least there is no likelihood that this absurd provision will be repealed. In the meantime it is improbable that accountants will be largely employed and the country will lose the service of experts which many of us think could be profitably utilized.

We believe that no accounting firm has ever made a vast amount of profit out of government work. In many cases work has been undertaken practically at cost. Therefore from a financial point of view the new law will not work any hardship upon accountants but it is a sad commentary upon the congress of the country that in this year of grace it should adopt a ruling so diametrically opposed to the spirit of the age.

MEMORANDUM ON THE RIGHT AND DESIRABILITY OF EXPERTS TO CHARGE HIGHER RATES FOR THE SERVICES OF THEIR ASSISTANTS THAN THE COMPENSATION DIRECTLY PAID TO SUCH ASSISTANTS.

BY ROBERT H. MONTGOMERY,

President, American Association of Public Accountants

The employment of so-called "experts" has greatly increased during recent years. These "experts" include professional engineers, public service management associations, chemists, accountants, statisticians and others. The increased call for their services by public and private clients of the very highest intelligence, official position and business standing proves without further argument that the necessity for such services exists, and the services rendered must at least approximate the expectations of clients or the demand would diminish instead of increase.

The service *cannot* continue if it should become the practice for a client to insist upon the right to deal directly with the organization of the "expert," the term "organization" including not only the individual members of the staff employed upon a particular engagement for a client but necessarily includes the office employees, such as stenographers, typists, proof readers, telephone operators, office clerks, *et al.*

Furthermore, an organization of the size now demanded to care adequately for important and confidential engagements must maintain commodious offices, equipped with modern mechanical devices, and fire and burglar proof filing facilities, and such an organization is expensive—more so than may be necessary to meet the minimum demands upon it. The office staff receive higher compensation than may be deemed to be necessary by those not familiar with all of the aspects

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of the question, but unless the organization is maintained upon the basis of ability to take care of maximum requirements it will completely break down at the very moment when the necessity for its existence is greatest.

Although dealing with professional services the principle involved is paralleled by business organizations which are held up as models of the highest efficiency. The owner of an iron furnace in selling pig iron would resent the suggestion of a prospective purchaser to pay wages directly to the laborers who made the iron. He would very properly suggest that the cost of iron includes items of depletion of mines, use of plant, supervision of executives and clerks and similar charges. A banker who lends money at five per cent would resent the suggestion of a borrower that he pay direct the two per cent which the banker pays upon the balances of his depositors. A lawyer who charges a fee would resent the suggestion of his client to pay his clerks or other office employees.

The suggestion is made, however, that public accountants whose services are required by departments of the federal government shall delegate to the government the payment of their assistants, thus in effect imposing upon the latter the very doubtful policy of accounting to their employers for the difference between their normal salaries and the amount received from the government. It is obvious that such a system would demoralize an otherwise efficient staff. The *per diem* rate paid by the government covers many elements besides the specific or *pro rata per diem* salary accruing to the accountant who is a member of a staff of accountants. There must be a considerable margin for unemployed time, sickness and vacation of the individual employed, as well as a proper proportion of the expenses of maintenance of the organization referred to above.

It cannot be urged that the government can ever secure the services of competent accountants who will be free from these "over-head" expenses. If an accountant is practising alone and is therefore not obliged to account to any one else for the *per diem* received for his services, his "over-head" is relatively higher than is the case with a firm of accountants maintaining a large staff. The service demanded from practitioners of any profession requires that they be available when needed. The existence of a large number of solitary practitioners, without offices and office facilities, could never avail for sporadic demand. If the service is of a continuous character, a permanent staff should be organized. If the demand is intermittent, as it inevitably is, those requiring the services must know where to find competent men. It so happens that the work is not only intermittent but it is of a character which demands the highest possible ability to perform. Accountancy is a profession which calls for long practical experience as well as theoretical and technical training, otherwise in undertaking an important investigation the untrained man will be acquiring his experience and skill as he goes along, and at the expense of some one else, instead of starting in with it. Cases are not infrequent where investigations conducted by inexperienced men cost many times as much as those undertaken by experienced men who know what to eliminate and what to do.

Obviously, the inexperienced must gain experience but it can be done efficiently and economically, rather than at the cost of the government as would be the case if the proposed bill becomes a law. For instance, suppose a specific investigation is to be undertaken. It is estimated that six accountants should be employed. It might be possible to secure the services of six detached and otherwise unemployed accountants at \$15.00 a day each, or any one of several firms of accountants could furnish an experienced senior at \$50.00 a day and five assistants at \$15.00 a day each. In one case the government would pay \$75.00 a day—in the other case \$125.00 a day. Now about the results? The individuals would

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have no responsibility except to themselves; they could work or quit as they liked. They could not have back of them an established organization with its attendant expense or they would not be working for \$15.00 a day. They could not have long and varied experience or they would not be available. In other words, it would be a gamble, pure and simple—"Heads I win, tails you lose" for the men as against the government. It might easily be that at the end of the engagement the men would have acquired valuable training and be better equipped for the next time, but it surely would take them twice as long and the results would not be as dependable as if the investigation were conducted along scientific lines.

If the \$50.00 a day man were in charge of five others at \$15.00 a day (or at any other rate) the government would have, in effect, the benefit of the services of six \$50.00 a day men. One thoroughly qualified accountant can readily supervise the work of a number of others. There is more or less detail in investigations. It can be done in a \$50.00 a day way or in a \$15.00 a day way. If the \$50.00 a day man is in charge of his own assistants all of the work will be done his way and time will not be lost in experiment, duplication and wholly unnecessary work.

True, the \$15.00 a day men will not be paid \$50.00 a week salary, but they will not work 313 days a year, and all of the expenses of the organization to which they belong will have to be paid before any part of the difference between their salaries and \$15.00 a day can be considered as profit. As a matter of fact some of the assistants might receive very low salaries, and if the English custom can be adopted here some of them may pay their firms instead of being in receipt of a salary.

It has never been contended that the work of a law clerk, serving his apprenticeship, should not be charged for by a lawyer—the *work performed*, the *service rendered* have been and always must be the measure of compensation. To put professional services on the plane of trade unions with a uniform wage for a far from uniform service would be ludicrous. The most expensive workmen frequently are those to whom the lowest compensation is paid. The most economical are those to whom the highest compensation is paid. The higher a man stands in his profession the more jealously he guards his reputation, the more anxious he is to give a *quid pro quo*.

If the provision in question is enacted into law it will automatically put beyond the reach of the government the most skillful and experienced professional men, thus depriving it of services which might be of unquestioned advantage and profit. On the other hand, the demand for expert services is so insistent and general that such services will be secured, and, if competent men cannot be found, incompetent and inexperienced men will be employed to the detriment of the government in respect of results achieved. And the inferior work, inevitable under such conditions, will cost more than if a way is found to retain the services of qualified practitioners.

American Association of Public Accountants

REGULAR SEMI-ANNUAL MEETING OF TRUSTEES

The regular semi-annual meeting of the board of trustees of the American Association of Public Accountants was held at 11 a. m., Monday, April 13, 1914, at the Lawyers Club, 115 Broadway, in the city of New York.

Present:

President R. H. Montgomery in the chair

Messrs Carl H. Nau (treasurer)

John A. Cooper

H. S. Corwin

W. S. Davies

J. B. Geijsbeek

J. S. M. Goodloe

T. U. Hare

E. L. Hatter

C. E. Lord

F. C. Manvel

E. P. Moxey

W. H. Rand

W. E. Seatree

E. W. Sells

E. L. Suffern

W. F. Weiss

A. P. Richardson (secretary)

The minutes of the preceding meeting were approved.

The following reports were received:

Report of the treasurer

" " " secretary

" " " executive committee

" " " committee on accounting terminology

" " " committee on Journal

" " " committee on state legislation

" " " special committee on professional ethics

Oral reports were made on behalf of the committee on annual meeting, the committee on arbitration, the committee on education, and committee on federal legislation.

A letter was read from the New York State Society of Certified Public Accountants covering a report of a committee of that society and requesting that the by-laws of the American Association of Public Accountants should be altered so that no dues should be exacted by the association on account of:

1. Members-at-large of the American Association, who are likewise members of this society and who pay their own dues direct to said association.

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2. Junior members as they cannot have representation in the American Association.

3. Members who cannot be admitted to fellowship in the American Association by reason of the requirements of said association; and it should be borne in mind that certified public accountants certificates are now issued in this state only to those who have had at least two years of accounting practice in the office of a public accountant.

It was pointed out that the first two classes of members mentioned do not at present pay dues to the association.

The secretary read a brief prepared under instructions of the executive committee setting forth the history of the relations between the American Association of Public Accountants and the New York State Society of Certified Public Accountants.

After discussion it was moved, seconded and unanimously carried:

That the committee on constitution and by-laws be instructed to prepare for submission to the next annual convention of the association the following proposed amendments to article V of the by-laws.

Section 4 shall be amended to read as follows:

"No dues shall be required to be paid by any state or district society for those of its members who may not be entitled to become society fellows of this association, unless at their own request they shall become associates of this association."

Existing sections 4, 5 and 6 shall be advanced one number and shall read sections 5, 6 and 7 respectively.

Article II, section 7 of the constitution shall be amended to read as follows:

"Upon the admission to membership of any fellow or associate in any state or district society which has been admitted to this association the secretary thereof shall report such member to the secretary of this association, provided such member shall possess the qualifications necessary for his admission as a fellow to this association, but not otherwise, unless such member shall himself request that he be admitted as an associate and upon his election by the board of trustees such member shall become a fellow or associate of this association subject to the provisions of sections 2 and 3 of this article. Society membership in this association shall cease when any member ceases to be a member of any constituent state or district society."

And all articles or sections of this constitution and by-laws in conflict with these amendments shall be null and void.

The committee on membership submitted its report and the following were elected members of the association:

Missouri Society of Certified Public Accountants:

Fellow:

W. W. Rankin, C. P. A.

Ohio Society of Certified Public Accountants:

Fellows:

John B. Geijsbeek, C. P. A.

Charles Byron Williams, C. P. A.

Oregon State Society of Certified Public Accountants:

Fellows:

Albert Lester Andrus, C. P. A.

George Parker Clark, C. P. A.

Max Crandall, C. P. A.

Joseph Gundry Gillingham, C. P. A.

C. A. Mackenzie, C. P. A.

Seth L. Roberts, C. P. A.

Trustees' Meeting

Minnesota Society of Public Accountants:

Fellow:

Frederick G. Colley, C. P. A.

Associates:

Clare L. Rotzel, C. P. A.

William Guthrie, C. P. A.

Certified Public Accountants of Massachusetts, Inc.:

Associate:

W. Chester Gray, C. P. A.

Washington Society of Certified Public Accountants:

Fellows:

H. W. Carroll, C. P. A.

J. D. Currie, C. P. A.

A. S. Hansen, C. P. A.

George W. Klinefelter, jr., C. P. A.

S. Edwin Linz, C. P. A.

W. Mayors, C. P. A.

E. J. Miner, C. P. A.

Wisconsin Association of Public Accountants:

Fellows:

Leslie S. Everts, C. P. A.

Arthur G. Jones, C. P. A.

Carl Penner, C. P. A.

John E. Reilly, C. P. A.

Edward H. Schroeder, C. P. A.

Delaware Society of Certified Public Accountants:

Fellows:

W. A. Clader, C. P. A.

Clifford E. Iszard, C. P. A.

T. Whitney Iszard, C. P. A.

Edward M. Stradley, C. P. A.

Peter T. Wright, C. P. A.

The chairman of the committee on membership reported that applications for membership from the New York State Society of Certified Public Accountants, the Virginia Society of Public Accountants, Inc., and the Colorado Society of Certified Public Accountants had been received after the meeting of the membership committee.

Action was deferred until the trustees' meeting in September.

A communication from Mr. J. S. M. Goodloe relative to the Ohio Society was referred to the executive committee for action.

The names of fellows at large who under the revised by-laws had ceased to be members for failure to pay their dues within five months after the annual meeting were read.

The deaths of Messrs. Joseph H. Kingwill of Colorado and Charles Lewer of Pennsylvania were announced and resolutions of regret and sympathy were passed with instructions that copies thereof should be transmitted to the respective families.

Meeting adjourned.

Income Tax Department

EDITED BY JOHN B. NIVEN, C. P. A.

The rulings published by the treasury department since the last issue of THE JOURNAL, are printed as usual in this number, and are as follows: Ruling No. 1956 which provides for inquiries addressed to Washington to be answered in the offices of collectors.

Ruling No. 1957 which holds that the income of partnerships as such is not subject to tax, nor according to the provisions relating to deduction at the source, but that partnerships have to file certificates as evidence of ownership in ordinary course.

Ruling No. 1960 which gives an interpretation of the provision of the law designating the interest to be deducted in the returns of corporations. This was referred to in last month's JOURNAL.

Ruling No. 1961 which provides for the ownership of bonds by fiduciaries having the control of more than one estate, being declared on the one certificate.

Ruling No. 1962 which reminds collectors and others that income tax returns are inviolably confidential.

Ruling No. 1965 which directs that payment of tax retained is *not* to be accepted from the withholding agent until the thirty days allowed for reclaiming have expired.

Ruling No. 1967 which advises that corporations exempt from taxation are also exempt from the provisions relative to withholding agents.

TREASURY RULINGS

(T. D. 1956 February 14, 1914)

Inquiries relative to the income tax covered by regulations and rulings to be answered by collectors.

A large part of the volume of correspondence coming to this office asking for information relative to making return and ascertainment of net income, etc., for the income tax, is sufficiently covered by regulations, and should be answered in the offices of collectors.

Collectors have been furnished with copies of regulations No. 33, and will be advised from time to time of additional rulings in income-tax matters.

Collectors are therefore advised that letters coming to this office asking for information which should be supplied by collectors in accordance with instructions and regulations furnished them will be referred to collectors for reply and writers of the letters advised of the reference. Collectors, upon receipt of letter referred to them by this

Income Tax Department

office, will give immediate attention to the subject-matter of the inquiry, in accordance with the regulations and instructions bearing upon the same.

(T. D. 1957 March 12, 1914)

Partnerships are not subject to income tax, but are required to file certificates of ownership of bonds, etc., in connection with coupon and registered interest payments to prevent withholding of their income at the source.

Referring to the following provision in paragraph D of the income-tax law—

That any persons carrying on business in partnership shall be liable for income tax only in their individual capacity, and the share of the profits of a partnership to which any taxable partner would be entitled if the same were divided, whether divided or otherwise, shall be returned for taxation and the tax paid, under the provisions of this section, and any such firm, when requested by the commissioner of internal revenue, or any district collector, shall forward to him a correct statement of such profits and the names of the individuals who would be entitled to the same, if distributed—

it is held that the income of partnerships *per se* is not subject to the income tax. The provisions of the law "relating to the deduction and payment of the tax at the source of income" do not apply to the income of partnerships as such. Taxable members of partnerships will be required to account, in their individual returns, for their respective shares or interest in the partnership profits, whether the same are divided and distributed or not.

Partnerships owning "bonds and mortgages, or deeds of trust, and other similar obligations of corporations, joint stock companies or associations, and insurance companies," shall file certificates of ownership, in form 1001, evidencing the fact of partnership ownership when presenting for collection or payment coupons or interest orders for interest upon said obligations; and when such certificates are filed, the tax on such interest payments to partnerships shall not be withheld.

The last sentence in article 14, page 35, and article 47 of income tax regulations No. 33, providing for claim by partnerships for deduction for legitimate expense incurred in conducting the business of a partnership, are hereby superseded and repealed.

(T. D. 1960 March 18, 1914)

Corporations are allowed by law to deduct interest actually accrued and paid within the year on an amount not in excess of paid-up capital stock outstanding at the close of the year, plus one-half the interest-bearing indebtedness then also outstanding.

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Your attention is called to that provision of the income-tax law designated as the third deduction, subdivision (b), paragraph G, reading as follows:

The amount of interest accrued and paid within the year on its indebtedness to an amount of such indebtedness not exceeding one-half of the sum of its interest-bearing indebtedness and its paid-up capital stock outstanding at the close of the year, and if no paid-up capital stock, the amount of interest paid within the year on an amount of its indebtedness not exceeding the amount of capital employed in the business at the close of the year.

It is held that in the case of a corporation having capital stock this deductible interest is interest actually accrued and paid within the year on an amount of indebtedness not exceeding the paid-up capital stock outstanding at the close of the year, increased by the addition thereto of one-half the interest-bearing indebtedness outstanding at the close of the year.

The qualifying phrase, "outstanding at the close of the year," appearing in the foregoing quotation, is held to apply to both paid-up capital stock and indebtedness, and "one-half the sum of" qualifies only the indebtedness, which indebtedness, like the paid-up capital stock, is required by the law to be reported, in making return of annual net income, as outstanding at the close of the year.

If no indebtedness is outstanding at the close of the year, the maximum deduction allowable on account of interest paid will be the amount of interest actually accrued and paid on an amount of indebtedness not exceeding at any time within the year the entire paid-up capital stock outstanding at the close of the taxable year; that is, in such case, the paid-up capital stock outstanding at the close of the year measures the highest amount of indebtedness upon which deductible interest can be computed.

For the purpose of an allowable deduction, interest on the maximum amount of indebtedness, determined in the manner above indicated, can be computed upon such amount only for the time during which such amount of indebtedness is not in excess of the paid-up capital stock, increased by one-half the sum of the interest-bearing indebtedness outstanding at the close of the year.

In any event, the amount of interest, in order to constitute an allowable deduction, must not only be within the limit of the law as herein defined, but must have actually accrued and been paid within the year for which the return is made.

In cases where no capital stock exists, the limitation as to deduction is confined to interest actually paid on an amount of indebtedness not exceeding at any time during the year the capital employed in the business at the close of the year.

Any provision in the regulations heretofore issued inconsistent with the foregoing is hereby revoked.

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(T. D. 1961 March 19, 1914)

Forms 1015 and 1019 may be adopted so that but one certificate will be required to be filed with coupons from the same issue of bonds, the property of different estates or trusts.

Under income-tax regulations No. 33, articles 39 and 70, fiduciaries are required to file certificates on form 1015 or form 1019, according to the nature of the claim to be made by the fiduciary, for each issue of bonds and for each trust.

It is therefore provided that where fiduciaries have the custody and control of more than one estate or trust, and said estates or trusts have as assets bonds of corporations, etc., of the same issue, said fiduciaries may adapt certificates form 1015 or form 1019 by changing the words "estate or trust" in lines two and three of said forms to the plural, and inserting in the blank space provided in line three of said forms for the *description of the estate or trust* the words "As noted on the back thereof." In such cases the notation on the back of the certificate should show for each estate or trust (a) the name of the estate or trust, (b) the amount of the bond, (c) the amount of the interest. In all other respects the certificates should be filled out as indicated thereon.

(T. D. 1962 March 20, 1914)

Information contained in income-tax returns to be treated as inviolably confidential.

The attention of collectors of internal revenue, internal-revenue agents, and other officers concerned is invited to section 3167 of the United States revenue statutes, which prohibits the disclosure of information contained in income and other returns of internal-revenue taxpayers.

All internal-revenue officers will preserve as inviolably confidential all income-tax returns, as the slightest infraction of law upon this subject will be severely punished.

(T. D. 1965 March 23, 1914)

Advance payment of tax withheld by withholding agents not to be made prior to thirty days preceding the date on which the annual return is required to be filed.

Attention is directed to note A appearing on the bottom of forms 1012, 1012c, 1043, and 1044, providing that—

Withholding agents may, if they so desire, pay at the time this list is filed, to the collector of internal revenue with whom the list is filed, the amount of tax withheld during the *month* for which the list is made,

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And to note A, form 1042, providing that—

The amount of the tax withheld during the year for which the list is made, may be paid to the collector at the time the list is filed.

In order that persons whose income tax is deducted and withheld and is to be paid at the source may have an opportunity to file with the source which is required to withhold and pay tax for them certificates claiming the benefit of deductions and exemptions provided for in paragraph B and allowed in paragraph C of the law, withholding agents will not pay to collectors of internal revenue the tax withheld by them under the law until after the time for filing claims for deductions and exemptions has expired. See regulations No. 33, art. 33, (a) and (b).

(T. D. 1967 March 25, 1914)

Organizations, etc., exempted by the first proviso of paragraph G of section 2 of the act of October 3, 1913, from payment of the income tax, are not subject to the provisions of the income-tax law as withholding agents.

This office is in receipt of several communications relative to the duty as withholding agents of religious corporations and other organizations which are specifically enumerated in the first proviso of paragraph G of section 2 of the act of October 3, 1913.

The language of said proviso is as follows:

That nothing in this section shall apply to labor, agricultural, or horticultural organizations, or to mutual savings banks not having a capital stock represented by shares, or to fraternal beneficiary societies, orders, or associations operating under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system, and providing for the payment of life, sick, accident, and other benefits to the members of such societies, orders, or associations and dependents of such members; nor to domestic building and loan associations; nor to cemetery companies, organized and operated exclusively for the mutual benefit of their members; nor to any corporation or association organized and operated exclusively for religious, charitable, scientific, or educational purposes, no part of the net income of which inures to the benefit of any private stockholder or individual; nor to business leagues; nor to chambers of commerce or boards of trade, not organized for profit or no part of the net income of which inures to the benefit of the private stockholder or individual; nor to any civic league or organization not organized for profit but operated exclusively for the promotion of social welfare.

You are therefore advised that the words "this section" are held to refer to and mean the whole of section 2 of the act of October 3, 1913, which section comprises the income-tax law, and that the words "nothing in this section shall apply to" were intended to relieve such organizations, etc., as properly come within the classifications referred to in the

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proviso quoted, not only from the payment of an income tax but from every obligation or requirement imposed by any or all of the provisions of said section upon withholding agents.

In the matter of *Brushaber versus Union Pacific Railroad Co.* referred to in last month's JOURNAL, to accelerate progress in the case the motion for its hearing in the district court was by mutual consent dismissed and an appeal taken to the supreme court, which has been allowed. The case was immediately placed on the calendar and will be heard by the supreme court in due course.

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EDITED BY SEYMOUR WALTON, C. P. A.

Deferred Debits and Credits

One of the advantages of the double entry system is that all the elements of a business can be taken into consideration. Instead of being confined to cash receipts and disbursements applying entirely to the period in which the money was received or paid, the effect of any particular item may be distributed to the period which must earn it if a profit, or which will receive the benefit from it, if an expense. These items in a balance sheet are carried as deferred debits or credits. They are assets and liabilities only in an accounting sense, as being advances made by the current year for account of the succeeding year, or obligations of the current year that will have to be met by the succeeding year.

These items are known as deferred charges to operation, accrued accounts receivable, deferred credits, and accrued accounts payable. They are of entirely different characters, and should never be lumped together in a balance sheet; much less should they be offset against each other when the total of the debit items happens to be virtually equal to the sum of the credit items.

Deferred charges to operating are those items which have been paid during the current year as expenses of the business eventually, but which are applicable only partly to the year in which they were paid, since the effect extends beyond that year and inures to a certain extent to the benefit of a subsequent year or years. Thus, a five-year fire insurance policy taken out and paid for on July 1 of any year benefits only half of that year and equally benefits the next four and one-half years. The current year is therefore entitled to charge nine-tenths of the premium to the future, carrying it in its balance sheet as a deferred charge of unexpired insurance. In a sense it is a real asset, since a part of the amount can be realized as return premium by cancelling the policy. As a going business must keep up its insurance, the actual value of the policy is never considered.

Interest paid in advance on notes payable or notes receivable discounted, when the notes are not due until some time during the next year, is a deferred charge proportionate to the time subsequent to the close of the current year. If the year 1914 enjoys the benefit derived from the use of the money provided by the year 1913, it can legitimately be called upon to pay its share of the interest paid to secure the money. This is equally the case with the loss suffered by the sale of an issue of bonds at a discount. The bonds are sold at a discount because the rate of yearly interest payable on them is too small to allow them to command par in the bond market. As each year that the bonds are outstanding makes a saving in the amount of interest that it is called on to

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pay, it must assume its share of the discount. In the meantime each year in turn carries as a deferred charge to the future the amount of bond discount remaining after this and the previous years have assumed their proportions by credits to bond discount and charges to bond interest.

Accrued accounts receivable are those items which have been earned or have accumulated during one period but which are not payable until a subsequent period. Interest on customers' notes, when they bear interest from date, is an instance. The amount accumulated during the current year is an earning of that year, although it will not be collected until after the close of the year. Accrued interest on bonds held as an investment is a similar item. The current year has an undoubted right to carry such accrued items as assets by considering them a charge against the year which will collect them.

Deferred credits are those items for which payment has been received by a period which has earned only a portion of them. Prepaid subscriptions to a periodical are not an earning of the month in which they are paid. Only one-twelfth of each subscription is earned each month as the periodical is printed and issued to the subscribers. To take the whole amount as an earning of the month in which it is received as a credit to the earnings of that month would be unjust to the subsequent months which will have to bear all the expense of the copies issued in those months. Each month is entitled only to its share of the amount and must carry forward the balance as a credit to subsequent months. A fire insurance company must do the same thing with the premiums it receives, crediting the profits of each month with no more than its proportionate share, and carrying the rest of the premiums forward as a credit to unearned premiums or re-insurance reserve.

Accrued accounts payable are those items to be eventually paid which have accumulated or have been incurred in one period for which payment is not due until a subsequent period. Interest on demand notes payable, or on open accounts payable, not payable until the principal is paid, cannot be considered entirely as an expense of the period which pays it, if a previous period has enjoyed the use of the money for a part of the time. The previous period must charge its interest account and credit accrued accounts payable, or accrued interest payable, as a credit to the subsequent period which will pay it, and which is thus relieved to that extent of the interest burden.

The most important of these accrued accounts payable are accrued bond interest, when a company has a large issue of bonds outstanding, and accrued taxes. Because coupons may not be due for one or more months after a statement is made, accrued bond interest is often ignored in the profit and loss statement and the balance sheet, although it seems self evident that each month must be charged with its proportionate share, since it is credited with its net earnings from operation.

Taxes are very frequently treated in an entirely erroneous manner. If they are paid, as in Illinois, on or before April 30, they are often considered as taxes for the year in which they are paid, and two-thirds of the amount paid is called taxes paid in advance. In C. P. A. problems

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we often find debit balances under that name. It may be possible that in some states this may be true, but in Illinois and many, at least, of the other states, taxes are never paid in advance. The taxes paid in April, 1914, are the taxes for the year 1913. They had all accrued on December 31, 1913, and in the balance sheet of that date they should appear for their full amount as an accrued account payable under the heading of reserve for taxes, or accrued taxes. In a monthly closing system, there would be four months' more taxes added to the credit of the reserve, so that by the end of April the reserve would represent the taxes for sixteen months. Charging the taxes paid to the reserve account would leave that account with a credit balance representing the taxes for the four months of the new year. Since the amount of the tax cannot be known at the beginning of the year, the reserve is usually based on the last year's tax and is adjusted when the tax of the current year is ascertained.

DIFFERENCES IN NATURE OF DEFERRED ITEMS

Because some of these items are debits and others are credits, it is often claimed that they can be offset against each other when the total debits are virtually equal to the total credits. An analysis of their nature will prove this view to be erroneous. A deferred charge to operating is only technically an asset. It will never be realized in cash, but will simply be taken care of by being charged against revenue in the succeeding period. An accrued account receivable is considered to be collectible in cash and, therefore, is a real asset whose realization is merely delayed. A deferred credit is not payable in cash, but is to be taken up into revenue at the proper time. An accrued account payable must be paid when it becomes due. It is a real liability whose payment is temporarily deferred. It would be manifestly wrong to offset nominal assets against real liabilities. Even in the case of accrued accounts receivable that are supposed to be actually collectible and accrued accounts payable that must be eventually paid no offset should be made, because the business is obliged to pay its own debts, and it may not be able to collect all the amounts due to it. Besides, the time at which accounts are due may make a difference. Accrued wages payable will be due within a few days, while accrued interest receivable may not be due for two or three months. Owing to this difference in character, the different classes of deferred items should be specified in a balance sheet, and not lumped under general terms of deferred debits and deferred credits. In a business which both receives and pays interest, there should be two interest accounts kept, interest receivable and interest payable, so that the total of each may be readily known.

To offset deferred items, even when they are of the same nature, is no more logical than to offset creditors against customers and thus to show net accounts receivable. In the automobile business customers will frequently make cash deposits to secure delivery of cars in the future. If these deposits are credited to their accounts in the customers'

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ledger and the balance of that ledger is shown in the balance sheet net as accounts receivable, this kind of an offset is made, and a false statement is the result. The deposits are positive liabilities, while the real accounts receivable are subject to shrinkage from bad debts. The deposits should be placed in a separate account and should appear in the balance sheet as a liability under the head of advance deposits.

TREATMENT IN THE BOOKS

It is contended by many, probably by a majority even of accountants, that a special account should be opened with each one of these deferred items, whenever the books are closed. Wages account is charged and accrued wages account credited with the proper amount, or insurance is credited and unexpired insurance charged, and so on. The result is that a large number of temporary accounts are opened on the last day or a period, only to be closed the next day by reversing entries. Sometimes, indeed, the accounts are not all closed again, but are carried through the ensuing year as unexpired insurance, or as we shall see, inventory of January 1, which is absolutely without any meaning and represents nothing whatever after a comparatively short time.

If there were any logical reason for this treatment, or any object gained, there would be no valid objection to the opening of these various accounts. The plea is made that there is a radical difference between interest as an expense of the business and interest paid in advance as an asset in the balance sheet, but there seems no valid foundation for it. If we discount a note for \$10,000.00 in bank and receive credit for \$9,600.00, we charge interest \$400.00 to balance. If we pay a demand note on which interest of \$400.00 has accrued, we also charge interest \$400.00. The account now contains two items, one of which is not really a present charge against revenue. If we close the books when the first note has run only one-quarter of the time to its maturity, we find that we have in the interest account the sum of \$300.00 which has been paid in advance. By bringing this amount down as a balance in the interest account, we have simply shown on the books a fact that has always existed, that part of the account was paid in advance and part was not. In other words, the interest account is a mixed account, partly nominal to the extent that the interest covers the past, and partly real to the extent that it is an asset in the shape of a deferred charge against the future. Eliminating the nominal element by a credit to the account and a charge to profit and loss, we have the real element left as a balance in the account, not as a different kind of interest to be transferred to some other account. To be logical, those who insist on the account being opened with interest paid in advance should carry that account always on the books, and should charge to it all prepaid interest, making transfers to the regular interest account each month as the time for which it was prepaid elapses.

The trouble seems to lie in a lack of a clear perception of what we really do when we close a certain portion of the balance of such an ac-

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count into profit and loss. We have fallen into the habit of saying that we credit the account with the portion that we expect to carry as an asset, or charge it with the amount that we have ascertained to be an accrued liability, but do we really do anything of the kind? A trick of speech does not make a principle, although some people seem to think it does. It is easier to say that the sun rose this morning than to state the true fact, but that does not change the astronomical law that the dawn is caused by the revolution of the earth on its axis.

The treatment of inventories illustrates this point more forcibly than does anything else.

INVENTORIES

At the end of the year we are told to credit our raw material account with the cost of the material on hand and then to credit the remaining balance. As each credit requires a debit, it is easy to see that the balance left must be charged to manufacturing cost, that is, eventually to profit and loss. The question as to what debit affects the other credit is answered by opening an account with inventory and making the debit to that account. In other words, we are asked to insist that the sun rose in fact and not merely in colloquial parlance. For the truth is that the credit of the inventory to the material account is not a credit at all and does not need any offsetting debit.

Our object in closing the material account, or any other account in which there is an inventory, is to ascertain how much material we have used in our manufacturing processes. If we were able to keep an absolutely accurate tally on the material during the year we would not need to pay any attention to the inventory. As the balance of the material account represents the total amount of material purchased, the elimination of the amount used would leave as a balance the value of the material still on hand. As we seldom or never are able to tell with precision what has been used, we have to go at it backwards, that is, we have to find out first what the balance on hand is before we can determine how much we have consumed. Ordinarily we make all the necessary entries in an account in order to ascertain the balance to be brought down. In accounts involving an inventory we are obliged to find our balance first and then make the necessary entry, but that does not change the real nature of the account.

Therefore, the inventory is inserted on the credit side of the account not because it is a credit entry, but because it is a balance left on hand after the amount used has been eliminated. Instead of being entered before the closing entry to profit and loss, it should be entered last as "balance, being inventory," and is then logically brought down as a debit balance in the account itself as a balance unconsumed.

This is the only logical treatment, because it exactly expresses the fact that the inventory is unconsumed material purchases. When the material is purchased it is put into bins or other appropriate places. As it is needed it is taken out. At the end of the year we find the balance

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on hand in the places where we put the purchases. Why do we not do the same thing with the account on the books? If there is any inherent difference between inventories and unused purchases, we ought, to be strictly logical, to move all our goods of whatever nature on hand at the end of the year into one room with INVENTORY over the door, and then the next day move them all back again. That is what we do when we charge them to an inventory on the books.

As the purchase account shows the total of the goods purchased to date, the balance of that account would indicate the amount used, if nothing was left on hand. The actual amount used is the balance, less the quantity left on hand—that is, the inventory. Theoretically, the inventory is, therefore, a deduction from the total purchases, and not a credit to them. This is the treatment given it when a revenue statement is prepared, showing first the net sales, then the cost of the goods sold, and so on. To the inventory at the beginning is added the net purchases, and from their sum is deducted the inventory at the end, to ascertain the amount used. By treating the inventory at the end as a balance to be brought down, this theoretical method is exactly followed in the books.

As the inventory is the balance of the purchases of material or other goods unused or unsold, so unexpired insurance is the balance of insurance on hand covering a certain portion of the future, the amount that was charged to profit and loss being the cost of the insurance protection for the period just closed. In exactly the same way, a certain amount of the interest paid in advance, or of the discount on bonds issued, has been taken up by a charge to profit and loss, in proportion to the elapsed time, leaving a balance in the account to be carried forward to the next period. Accrued wages or accrued interest on bonds or on demand notes payable outstanding are just the same kind of wages or of interest as those which have been paid, and would not seem to need special accounts by which to segregate them.

Objection is made to this method of keeping the accounts that it places in the balance sheet items that are apparently nominal accounts on the ledger. Persons making this objection seem to forget that there are many accounts that are called nominal, which in usual circumstances are really mixed. Wages, for instance, if they are paid up to Saturday night on Saturday, are closed in a nominal account at the close of business that day. By Monday night the account has become a real account by the liability for one-sixth of the wages for the current week. If the books are closed on Wednesday night, the real liability appears in fact, as it already existed in essence, by the credit to the account, and a charge to profit and loss, of the nominal element of wages used, which includes the wages for the half week which must be paid later.

PURCHASES

Many accountants consider that it is very important to show the amount of goods purchased during the year, and insist that a proper statement should begin with the inventory at the first of the year, the

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purchases during the year and the inventory at the end of the year. They claim that the purchases made during the year are a guide to a knowledge of what purchases will have to be made during the ensuing year. They seem to forget that the inventory January 1 merely represented goods purchased prior to that date, and that when they say that the inventory January 1, plus purchases, minus inventory December 31, equals amount used, they are really saying: purchases prior to January 1, plus purchases since, etc. Why they should discriminate between goods purchased before and those purchased after January 1 does not appear to be very clear, except to show the totally irrelevant fact that a certain amount was purchased during the year. It is irrelevant, because the important thing to know is how much was used during the year, regardless of when it was bought.

The amount of material or other goods purchased in any year is no criterion of the amount that it will be necessary to buy in any other year. As the amount used during the year is an indication, in a normal business, of the amount that will probably be needed during the ensuing year, the inventory on hand at the end of the year becomes important, since its size will determine whether purchases will have to be heavy or light, in order to keep up the normal amount necessary for the business. The inventory at the beginning is of no importance at all, as it has long ago been merged with subsequent purchases and has entirely lost its identity. The practice that many indulge in of carrying the inventory of January 1 clear through the year as a separate item on the trial balance does not seem to have any justification either in theory or as a statement of facts. The same is true of unexpired insurance carried through the year. All other deferred items are usually thrown back into their appropriate accounts by reversing entries, but inventory and insurance are frequently carried through the year.

While the transfer of these deferred items to special accounts may not be considered a serious mistake, it would appear to be useless, and to be important only as indicating the lack of a true perception of what the balances in the various accounts really are. The tendency of the present age is to eliminate useless entries, and in these cases the tendency may be encouraged for the reason that the entries are not only useless, but are also illogical.

PRINCIPAL AND INCOME

The complications arising in the settlement of questions as to what is principal and what is income are well illustrated in an answer recently published to a question involving the rights of life tenants and a remainderman. The following are the question and the published answer:

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PENNSYLVANIA

(November, 1913)

General Accounting

Question 1

The duly appraised inventory dated January 1, 1910, of the estate of John D. Hamilton, deceased, contained the following item:

| | |
|----------------------------------|-------------|
| 50 shares Plumbers National Bank | |
| \$100 each par value, at 550 | \$27,500.00 |

The bank for a period of years has consistently paid semi-annual dividends of 12%.

On February 1, 1910, the bank declared its usual 12% semi-annual dividend; wishing to increase its capitalization it paid the dividend in cash, and gave its stockholders the option of buying new stock at par to the amount of the dividend.

The executors endorsed and returned the dividend cheque, receiving in exchange the six shares of new stock.

Thereafter they sold stock as follows:

| | |
|-----------------------|---------------|
| March 1, 2 shares, at | \$500.00 each |
| 3, 2 " " | 495.00 |
| 15, 4 " " | 480.00 |

The income of the estate is payable to two sisters of the decedent, Helen H. Winter and Sarah H. Samuels, during their lives, and a brother, William B. Hamilton, is the residuary legatee.

In respect to the above transactions show the effect thereof upon the interests of each of the three beneficiaries. Give your calculations in full.

ANSWER TO QUESTION 1

In answering this question certain assumptions must be made, and for this purpose it is assumed, first, that the sisters survive to receive the amounts to which they are entitled; and, second, that the two shares of stock sold on March 1, together with the two shares sold on March 3 and two of the four shares sold on March 15, represent the six shares which have been purchased by the executors out of the amount of cash dividend received on February 1, 1910. On the basis of this assumption the two sisters of the decedent, *vis.*, Helen H. Winter and Sarah H. Samuels, are entitled to receive \$1,475 each, representing in each case one half of \$600 plus one half of the profits, aggregating \$2,350, arising through the sale of the six shares bought by the executors. These shares bought out of income still represent income and as such all amounts realized through sale thereof belong to the sisters of the deceased. In reference to William B. Hamilton, the remainderman, the amount which he will receive, on the basis of the same assumption, is reduced by \$140, by reason of the executors' transactions. This amount represents the loss arising through the sale of two shares of the stock sold on March 15

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at \$480 each, while the appraised value of each of these shares was \$550.

A summary of the results of the executors' operations together with the calculations producing the foregoing result is set forth as follows:

Principal Account

DR.

The accountant charges himself with principal received, as follows:

Jan. 1, 1910

Inventory and appraisement *vis*:

50 shares stock Plumbers National Bank at 550\$27,500.00

CR.

The accountant claims credit as follows:

March 15, 1910

Loss on sale 2 shares stock Plumbers National Bank:

Appraised at\$1,100.00

Sold for 960.00 \$ 140.00

Balance 27,360.00

\$27,500.00

Balance as above\$27,360.00

Composed of:

48 shares stock Plumbers National Bank

appraised at 550\$26,400.00

Cash 960.00 \$27,350.00

Income Account

DR.

The accountant charges himself with income received as follows:

Feb. 1, 1910

Cash received as dividend on 50 shares Plumbers National

Bank stock\$ 600.00

March 1,

Net gain on sale of 2 shares Plumbers National Bank stock

purchased on Feb. 1st, 1910:

Amount received\$1,000.00

Purchased for 200.00 800.00

March 3,

Net gain on sale of 2 shares Plumbers National Bank stock

purchased on Feb. 1st, 1910:

Amount received\$ 990.00

Purchased for 200.00 790.00

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March 15.

Net gain on sale of 2 shares Plumbers National Bank stock
purchased on Feb. 1st, 1910:

| | | |
|-----------------------|-----------|------------|
| Amount received | \$ 960.00 | |
| Purchased for | 200.00 | 760.00 |
| | | <hr/> |
| | | \$2,950.00 |
| | | <hr/> |

CR.

The accountant claims credit in distribution as follows:

| | | |
|---|------------|------------|
| Helen H. Winter (sister) $\frac{1}{2}$ | \$1,475.00 | |
| Sarah H. Samuels (sister) $\frac{1}{2}$ | 1,475.00 | \$2,950.00 |
| | | <hr/> |
| | | <hr/> |

COMMENTS ON THE ANSWER

A proper analysis of the question will show that the executors had two entirely different things to deal with when they collected the dividend cheque of \$600.00. One was a cash dividend of that amount, which clearly belonged to the life tenants. It is a vital point that the dividend was paid in cash, and not in six shares of the capital stock at par. If it had been paid in stock there might be a claim that the whole value of the shares thus received would be income, but it was not so paid. The other thing with which the executors had to deal was the right to subscribe to new stock to the amount of the dividend. This subscription right is held by the stockholders, and is inherent in them, even if the question did not state that the bank "gave its stockholders the option of buying new stock at par to the amount of the dividend."

The stockholder in this case was the estate. The life tenants were not stockholders, and not being stockholders, they possessed no subscription rights. The mere fact that the executors endorsed the dividend cheque and returned it in payment for the six shares has nothing to do with the principle involved. As a matter of fact, they had no right to use a cheque belonging to the life tenants, with which to pay for stock belonging to the estate. They should have paid for it with money belonging to the principal, if there was any available. If there were no funds available, they could have borrowed the dividend cheque, only in case the life tenants agreed to lend it.

MR. WILLIAM F. WEISS, in his masterly and exhaustive paper on *Principal and Income*, says: "Rights or privileges given to stockholders to subscribe for new stock at less than its market value have a value in themselves and belong to the principal, as do the proceeds from the sale thereof. The gain from such sale will usually be about balanced by a decrease in value of the old shares."

The crucial point is contained in the last sentence of the quotation. The estate held 50 shares worth \$27,500.00. When it received the six shares, it held 56 shares worth \$28,100.00, since the \$600.00 paid must be added.

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The new value is almost exactly \$500.00 a share. Unless the estate receives the six new shares, it has suffered a loss in market value, based on the old quotation, of \$2,500.00 on the original 50 shares. This market value held for only the first sale of two shares, then broke for some unknown reason. It seems a little difficult to explain why this loss should fall upon the remainderman—even more difficult than to explain why, in the above answer, the remainderman was obliged to accept the sale at 480 as being his stock and not the sale at 500.

The confusion arises from the difficulty of distinguishing between the money involved in a transaction and the accounting principle governing the transaction. Because the dividend cheque, which was income, was used to pay for the stock does not make that stock and its proceeds also income. The accounting principle involved is the question whether the subscription right was principal or income. The use of the dividend cheque merely constituted a loan from the life tenants, with or without their consent.

This view of the matter does away with the necessity for any assumptions such as are made in the answer, except the very obvious one that the life tenants were still alive.

The total amount received from the sale of the eight shares was \$3,910.00. Of this, \$600.00 must be given to the life tenants to repay the loan from them. The remainder, \$3,310.00 belonged to the principal of the estate, to be conserved for the remainderman.

ADJUSTING MONTHLY STATEMENTS

I have been requested to answer the following question:

"A manufacturing concern is departmentalized to the extent that it has a separate department for handling one class of its product while the balance is simply called 'regular.'

"As fast as goods are manufactured for the special department they are passed on to the inventory of that department and 'regular' production credited at manufacturing cost.

"Profit and loss, asset and liability and financial statements are issued monthly. Through an oversight some \$1,400.00 worth of merchandise manufactured during a certain month for the special department is not carried into that inventory and is left out of the regular inventory. The three sets of statements are finished at the time the oversight is discovered. Should the person in charge of the statements refuse to change same because statements are late, and on what authority?

"Also: the statements not being changed is it or is it not correct for the person informing the cost department to write that the profit and loss statement is 'out' by the amount of the merchandise omitted."

In my opinion, the person in charge of the statements has no right to refuse to change the statements, simply because his reports will be delayed in consequence. The omission of the \$1,400.00 worth of goods from the accounts entirely will falsify the results not only of the special department, but of the whole business as well, reducing the profit for the current month and increasing it to the same extent for the succeeding

Students' Department

month. In a comparison of the two months there will be a false increase of \$2,800.00, unless the error is corrected at the beginning of the second month through a surplus adjustment account. There would seem to be no excuse for sending out statements that were known to be wrong, unless the difference is too trivial to be worth noticing. Indeed, if the statements had already been sent out before the error was discovered, corrected statements should be prepared and sent to those receiving the first ones, with the request that the first statements be destroyed, and the second ones substituted for them.

The last paragraph of the question is not very clear. Taking it to mean that the omission of the amount of the inventory has thrown the profit and loss statement out to that extent, there is no doubt that this is true. If the amount had been included in the regular instead of the special inventory, the effect would have been to increase the profits of the regular department and to decrease those of the special department. The net result of the whole business would have been the same. Leaving it out entirely reduced the profits of the special department and of the whole business for that month.

Principal and Income

By W. F. WEISS

Comments on Request of Mr. Seymour Walton on the question and answer on the above subject published under the title:

Pennsylvania - - November, 1913
General Accounting - - Question No. 1
and
Answer to this Question No. 1 and Mr. Walton's
"Comments on the Answer" - - - -

As I substantially agree with MR. WALTON's comments on the answer, my own comments therefore only take the form of an amplification of points and arguments supported by an expression thereof in the accounts affected.

The accounts to be dealt with are only such of the executors and testamentary trustee as relate specifically to the transactions and beneficiaries involved. The several assumptions in the first part of the answer appear unnecessary under the question—not even that the life tenants survive. The question clearly requires the effect only "upon each of the beneficiaries" named. There is no special provision for the disposition of the income, in case of the death of the life tenants; it is the dominating issue of the question, therefore, that the executors and trustees are accountable to some one for the income—the life tenants or their heirs, executors or assigns. Assumptions beyond that would raise new issues, not within the scope of the question.

The answer does not take into account, according to practice, procedure

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and precedent, one vital issue of the question, *vis.*, "that the bank gave its stockholders the option of buying new stock at par to the amount of the dividend." This dividend was 12% and of course on the par value of the stock. The estate appraised the actual value of the stock at 550. The option to the stockholders to buy new stock, at par, to the amount of the dividend, therefore had a value. Such options are generally and briefly called "rights." They are evidenced at times by announcements only—at times "rights certificates" are issued, which become negotiable when endorsed by the stockholder to whom they are issued. Rights belong to the stockholders, and attaching to the stock are always principal, and if sold the proceeds belong to the principal. Rights become valuable on account of accumulated surplus earnings; but the issue of new stock, for which only par is paid under such "rights," does not represent a distribution of earnings—it merely increases the number of shares and dilutes the shares as they existed before. Rights, therefore, although valuable are not income. As MR. WALTON quotes from my treatise on the subject of *Principal and Income*, the gain from sale of rights (and there might be added, from the avail of rights) will usually be about balanced by a decrease in the value of the old shares. (*Moss's Appeal* 83, Pa. St., 264—*Biddles Appeal* 99 Pa. St., 278—*Hite's Devisees v. Hite's Ex'r.* 93 Ky., 257—*Greene vs. Smith* 17 R. I., 28—*Peirce vs. Burroughs* 58 N. H., 302.)

Rights attaching to the stock, the stockholders in this instance being the estate, the proceeds from the avail of the rights in this case belong to the estate—that is to the principal of the estate. The executors had two separate and distinct functions to perform in this case: (1) To receive the cash dividend and, this being clearly income, eventually to pay it to the life tenants to whom it belonged; (2) to avail, on behalf of the estate as stockholder, of the "rights" and purchase six new shares at par for account of the principal of the estate. The use of the dividend cheque for this purpose was in fact an act *ultra vires*, but, assuming they acted in good faith, they and the principal became indebted therefor to the income and in turn to the life tenants.

Thus reviewing the theory and conclusions set forth in the answer that "the shares bought out of income, still represent income," it will have become clear that the purchase out of income was unauthorized and unwarranted in the first place; and, in the second place, that in fact the purchased new shares do not represent income but constitute part of the principal and as such the amount realized from their sale belongs to principal. The accounts in the answer therefore appear incorrectly stated.

Holding to the question "to show the effect of the transactions upon the interests of each of the three beneficiaries," I append hereto, by way of illustration, a set of accounts with condensed postings about as they should show the several transactions and the resulting balances. Entries themselves and dates are omitted. The bracketed reference numbers indicate the corresponding debit and credit of each entry.

Students' Department

BANK STOCK

| Dr. | | Cr. |
|----------------------------|--------------------|---------------------------------|
| To principal-inventory (1) | | By principal cash (5) ... |
| 50 sh. P. N. Bk. 550 .. | \$27,500.00 | Sale 2 sh. 500\$ 1,000.00 |
| To principal cash (4) .. | | " 2 " 495 990.00 |
| 6 sh. P. N. Bk. par.... | 600.00 | " 4 " 480 1,920.00 |
| | | By balance 24,190.00 |
| | <u>\$28,100.00</u> | <u>\$28,100.00</u> |
| To balance | \$24,190.00 | |
| 48 sh. P. N. Bk. | | |

PRINCIPAL OF ESTATE (Personal Property)

By inventory (1)\$27,500.00

INCOME CASH

| | | |
|--|--------------------|-------------------------------------|
| To dividend (2) | 600.00 | By loan principal cash (3)\$ 600.00 |
| To repayment from principal cash (6) | 600.00 | By balance 600.00 |
| | <u>\$ 1,200.00</u> | <u>\$ 1,200.00</u> |
| To balance | \$ 600.00 | |

PRINCIPAL CASH

| | | |
|------------------------------------|--------------------|--------------------------------|
| To loan from income cash (3) | \$ 600.00 | By bank stocks purchase |
| | | 6 sh. P. M. B. (4) ..\$ 600.00 |
| To sale-P. N. B. stock | | By repayment to loan to |
| 2 shares 500 (5) ... | 1,000.00 | income cash (6) 600.00 |
| 2 " 495 | 990.00 | By balance 3,310.00 |
| 4 " 480 | 1,920.00 | |
| | <u>\$ 4,510.00</u> | <u>\$ 4,510.00</u> |
| To balance | \$ 3,310.00 | |

DIVIDENDS

(Income Acct. payable to life tenants)

By income cash (2) ...
dividend 12%
50 sh. P. N. Bk. stock 600.00

TRIAL BALANCE

| | | | |
|------------------------------------|--------------------|--|--------------------|
| Bank stocks, 48 sh. P. N. Bk. | \$24,190.00 | Principal of estate personal property | \$27,500.00 |
| Principal cash | 3,310.00 | Dividends (income a/c) payable to life tenants | 600.00 |
| Income cash | 600.00 | | |
| | <u>\$28,100.00</u> | | <u>\$28,100.00</u> |

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The intention in the above is to convey the interpretation and effect rather than the exact wording. The accounts of the beneficiaries are omitted for brevity's sake. The principal of estate, \$27,500, consisting of 48 shares of bank stock at the value of \$24,190 and principal cash of \$3,310, is conserved for the remainderman. The dividend account balance is to be carried as income to the credit of the life tenants' accounts, to which latter accounts the income cash is to be charged when paid over to them.

The bank stock of 48 shares is at this stage shown at its present book value, arising from the first appraisal, from the purchase of the six shares and the sale of eight shares. This book value of \$24,190 plus the principal cash of \$3,310, aggregating \$27,500, thus shows the principal of the estate to be intact. Generally speaking, executors must account for profits made and are responsible for losses (*Baker vs. Disbrow*, 18 Hun. 29; 79 N. Y., 631) unless the will provides special latitude for investments. If investments are made according to law or to special authority under the will, the executors are only liable for losses resulting from negligence. The executors would thus appear responsible and chargeable for the loss of \$140, shown in the answer as chargeable to the remainderman, unless the terms of the will provided special authority and latitude.

It will be instructive to note further that any increase in the value of this stock, under appraisal at a future intermediate or final accounting, or any profit realized from the sale of this bank stock, belongs to the principal of the estate. "Increase" and "income" are not synonymous terms. Increase, coming from increased value of the principal, and the profits realized from such increase in estate accounts are not income but accretions to principal—except in such cases where it may be part of the regular business of an estate to deal in investments for profit.

W. F. WELLS.

Maryland C. P. A. Law Amended

The Maryland legislature has passed a bill amending the C. P. A. law of that state and providing for reciprocity.

The text of the amending act follows:

An act to amend article 75 A of the code of public general laws of Maryland (BAGBY's edition), title *Public Accountant*, by the addition of a new section to be designated section 5 A.

Section 1. *Be it enacted by the General Assembly of Maryland*, that article 75 A of the code of public general laws of Maryland, (BAGBY's edition), title *Public Accountant*, be and the same is hereby amended by adding a new section to follow section 5, to be known as section 5 A, said section to read as follows:

5 A. Any citizen of the United States or person who has declared his intention of becoming such citizen, over the age of twenty-one years, who holds a valid and unrevoked certificate as a certified public accountant, or the equivalent thereof, issued by or under the authority of any other state of the United States, or the District of Columbia, or any territory of the United States, or by or under the authority of a foreign nation, showing that the holder thereof has complied with the laws of such state, district, territory or nation, who desires to practise the profession of accountancy in the state of Maryland, shall present such certificate or its equivalent to the board of examiners of certified public accountants of this state, accompanied by a written application in form to be prescribed by the said board, with such information as said board may require as to the character and qualification of such applicant, and shall pay the said board the fee usually charged for examinations, and if the said board shall be satisfied that the standing of the said applicant and the requirements for a certificate as a certified public accountant of the state, district, territory or nation issuing the same are substantially equivalent to those established by the laws of this state, the said board may, in its discretion, register said certificate in a book to be provided by the said board for said purpose, and shall recommend to the governor the issuance to such applicant of a special certificate of registration designating the state, district, territory or nation issuing the original certificate to said applicant, which special certificate of registration, when issued by the governor, shall entitle the holder to practise as such certified public accountant, and use the abbreviation "C. P. A." in this state; provided, however, that no such special certificate shall be issued unless the state, district, territory or nation issuing the original certificate extends similar privileges to the certified public accountants of the state of Maryland.

SEC. 2. *And be it enacted*, That this act shall take effect from the date of its passage.

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Pennsylvania Institute of Certified Public Accountants

At the annual meeting of the Pennsylvania Institute of Certified Public Accountants, held April 20, 1914 the following officers were elected to serve for the ensuing year, and the following delegates and alternates to represent the institute at the annual meeting of the American Association of Public Accountants:

President, Edward P. Moxey (re-elected); vice-president, Wm. W. Rorer (re-elected); treasurer, Theodore H. Bird; secretary, Wm. J. Wilson (re-elected); auditor, John R. Lynn; council, R. H. Mansley (re-elected); Wm. R. Main.

Delegates: Edward P. Moxey, J. E. Sterrett, James W. Fernley, T. Edward Ross, August Hiller and George Wilkinson.

Alternates: John R. Lynn, Edward P. Moxey, Jr., Joseph M. Pugh, Herbert G. Stockwell, Ernest Crowther and Horace P. Griffith.

Council Hold-overs: Herbert G. Stockwell, James W. Fernley and T. Edward Ross.

Pittsburgh Branch, Pennsylvania Institute

The Pittsburgh branch of the Pennsylvania Institute of Certified Public Accountants has received its charter from the parent organization. Such a plan as this has been under consideration for some time because the distance between the eastern and western ends of the state of Pennsylvania is such that it is a difficult matter for members at one end to attend meetings at the other.

The new chapter consists of the following members: Messrs. Frank Wilbur Main, Ernest Crowther, J. C. Scobie, William G. Rebbeck, Elmer E. Staub, W. Sarel Lynne, and August Hiller. The chairman is Mr. August Hiller, the vice chairman, Mr. W. Sarel Lynne, and the secretary and treasurer, Mr. Ernest Crowther. The constitution and by-laws of the chapter are practically the same as those of the institute.

This constitutes the third state society to adopt the chapter system. Missouri was first and California second.

New Jersey County Audits

In March a request was made upon the board of chosen freeholders of Essex County, New Jersey, by the public welfare committee for permission to employ a New York organization to make an audit and a survey of the said county for the years 1912-1914.

The freeholders refused the request, stating that the same should be made by certified public accountants of New Jersey and appointed for that purpose W. Foster Oakes, C. P. A., Frank G. DuBois, C. P. A., and Leonard H. Conant, C. P. A.

News of State Societies

Georgia Society of Certified Public Accountants

At the annual meeting of the Georgia Society of Certified Public Accountants, held in Atlanta on March 23d, the following officers were elected: President, Joel Hunter, Atlanta; vice-president, Alonzo Richardson, Atlanta; secretary-treasurer, Charles Neville, Savannah. Aldon F. Thompson, C. P. A., was elected to membership in the society.

The Colorado State Board of Accountancy

At the December, 1913, examinations conducted by the Colorado State Board of Accountancy the following candidates were successful: Clarence H. Fulton, Denver; Albert Edward Keller, Denver; Ralph B. Mayo, Denver; Reginald Thomas, Chicago, Ill.; Ethan Allen Whitney, Denver.

Institute of Accountants and Auditors of Quebec

The Institute of Accountants and Auditors of the province of Quebec held its inaugural dinner at the Ritz-Carlton, Montreal, on Saturday, April 25th. Representatives of the government of the province, chamber of commerce, board of trade, commercial schools, etc., were present as well as representatives of the chartered accountants of Montreal. Georges Gonthier, president of the association, presided.

Wisconsin State Board of Accountancy

The Wisconsin State Board of Accountancy held examinations at Madison, Wisconsin, on April 16, 17 and 18. Thirty-one candidates sat for the examination.

Accountancy Recognized by Columbia University

It is a pleasure to announce that R. H. Montgomery, C.P.A., president of the American Association of Public Accountants, has been appointed assistant professor of economics at Columbia University. This constitutes a gratifying recognition of accountancy and should have considerable effect upon the status of the profession generally. Columbia University has always stood for the highest standards and it is eminently satisfactory that a member of the accounting profession should receive the signal honor of an appointment to the faculty.

Correspondence

New and Valuable Definitions

Editor, The Journal of Accountancy:

Sir: There is something so delightfully novel in the under mentioned definitions of "resources" and "income" that I take the liberty of submitting them through the courtesy of THE JOURNAL to the committee on accounting terminology for their consideration.

The definitions referred to occur in the appeal by circular letter to the parishoners of an Episcopal church not a hundred miles from the Hudson River.

Respectfully,

A MEMBER AT LARGE.

April 6, 1914.

"It is only proper and fair that you who do much to support this branch of the church, should know fully of *its needs, its resources and its expenditures.*

"The Vestry, therefore, make the following report so that you may know what the Church membership can do, ought to do, and do do.

"There is a difference between Resources and Income.

"Resources means what you can do.

"Income means what you do do.

"For instance, this Church has 700 Communicants and members; and 300 attendants and supporters who give more or less regularly to the Church. These attendants and supporters represent the *do doers* and they give their offerings and envelopes, \$2,870 per year or \$9.56 per person.

"The *can doers*, or Communicants and members who *do not give regularly*, would, if they gave in the same proportion as the *do doers*, increase the Church's Income \$3,824 per year. This is the reason why our Resources are greater than our Income.

"The Church is now trying to increase *its income* by asking *its Resources* to give regularly according to their ability.

"Now the *needs* of the Church are not always shown by the expenses, but vary according to how efficient and economical the management is.

"The primary aims of the Vestry are that the management shall be both efficient and economical, therefore for our purposes the expenses do show the needs of the Church."

Announcements

The Maine Board of Accountancy announces that it has decided not to issue certificates except after examination. The law provides that no person shall be entitled to take the examination unless he has been a resident of Maine for at least a year or is a certified public accountant of another state or under the jurisdiction of a foreign government which extends similar privileges to certified public accountants of Maine.

Ernst and Ernst announce the removal of their New York office from Hanover Bank Building, to suite 1001-2-3-4-5 and 6, 27 Cedar Street.

Deloitte, Plender, Griffiths & Co., announce that they have removed their Chicago offices from 69 West Washington Street to 1857 Continental & Commercial Bank Building, 208 S. La Salle Street, Chicago, Ill.

George Lester Lemon, president of the Alabama State Association of Public Accountants, was married at Birmingham, Ala., on April 15th to Miss Beulah Lee Ellenwood.

It is announced that J. D. M. Crockett & Company and C. B. Couchman have entered into a partnership under the name of Crockett, Couchman & Company, certified public accountants, with offices in the Glendale Building, Kansas City, Mo., and also in Topeka, Kansas.

Herbert S. Greenwood, certified public accountant, announces the removal of his office from No. 44 to No. 50 Broad Street, New York.

Riedell & Parker, accountants and auditors, announce the removal of their offices from 366 Fifth Avenue to Room 504, 51 Chambers Street, New York.

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Joseph H. Kingwill

Announcement is made of the death of Joseph H. Kingwill, C. P. A., a fellow of the American Association through the Colorado Society.

Mr. Kingwill's death is a serious loss to the profession and to the national and state organizations. He was an earnest and energetic worker for better conditions and was one of the pioneers of the profession in the west.

Charles Lewer

Every member of the American Association of Public Accountants will learn with deep regret of the death of Charles Lewer, C. P. A., which occurred on April 4th. Funeral services were held on April 8th and were attended by many members of the Pennsylvania Institute of Certified Public Accountants and other members of the association.

Those who have attended the annual conventions of the association will recall the great interest which Mr. Lewer always manifested in the work of the profession and will never forget the genial and whole-hearted enthusiasm which he displayed at all times.

The entire accounting profession suffers a loss in the death of this excellent accountant and good friend.

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An Accountancy Laboratory

The Connecting Link Between Theory and Practice

BY ROBERT H. MONTGOMERY, C. P. A.

During recent years most of the applicants who have taken the examinations for the certified public accountant degree have failed to pass. Most of them, however, fail in one section only—practical accounting. Obviously as the purpose of the examination is to ascertain the applicants' professional qualifications the subject in which they fail is the most important one assigned, but it serves to exphasize what I frequently have told the students in my accountancy classes, *viz.*, "Practical accounting cannot be taught; it must be learned."

Some of us for a number of years have made a determined effort to teach accountancy. Our efforts have not met with complete success, and it is needless to say that we are dissatisfied. Of course great progress has been made when we consider the status of accountancy ten or fifteen years ago and, if it were not for the negligible percentage of applicants who pass the C. P. A. examinations, I would claim that the progress had been satisfactory; but the situation will remain far from satisfactory until some means is devised whereby the accountancy student can supplement theory with practice.

And accountancy, although perhaps the youngest of the recognized sciences, has not been alone in the failure to impart a knowledge of practical things in a practical way. Here are some figures from a survey of country schools in a large middle western region:

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"In all the schools linear measure is taught, yet in only one-fifth of them are tape-lines found; they all teach avoirdupois weight, yet less than a tenth of them have scales; they teach liquid measure, but only a fifth have any measures. In a third of the schools geography is taught without maps, and in more than two-fifths without globes. All of them seek to teach children things about this fruitful and wonderful earth, yet more than two-thirds of the teachers never step outdoors to vitalize a point by the fields, flowers, woods, rocks and streams near at hand."

Some time ago it occurred to me that some of our improved methods of reporting to clients might be extended to teaching. We now visualize many business operations and we find, for instance, that a business man may be more impressed by the lines of a chart which show a steadily increasing cost of product over a term of years than he was when the same information was expressed in figures alone. I felt that I would like accountancy students to see many complete sets of account books and records and to have an opportunity to analyze them and prepare trial balances and balance sheets and comment on their condition, etc., etc. Naturally, the students cannot visit a large number of outside offices and, if the plan is feasible, the books and records must be assembled where access on the part of the students is convenient and under proper supervision. Then the word "laboratory" occurred to me and when I consulted the dictionary I decided that an accountancy laboratory is just as necessary a part of the equipment of a school of accounts as is the blackboard or the chairs, and will, I hope, form a connecting link between theory and practice.

The new *Standard Dictionary* defines a laboratory as "a building or room fitted up for conducting scientific experiments, analyses, or similar work." There is no branch nor department of human activity which demands such a careful analysis of its elements, particularly with respect to the best method of imparting and acquiring a workable knowledge, as the science of accountancy.

Again quoting the dictionary we find that one of the definitions of science is "any department of knowledge in which the results of investigation have been worked out and systematized."

Therefore, an accountancy laboratory would seem to be a

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necessity, rather than an experiment, if we are sure that there is a general demand for a knowledge of accounts.

During the last twenty-five years I have been brought into contact with many professional and business men, and I have among my friends most of the active public accountants of this country, who in turn reach thousands of other professional and business men. From a careful analysis of my own experiences and those of other accountants I find that practically every man who during his professional or business career is obliged to deal with accounts, his own or someone's else, expresses strong regret that during his younger or school or college days he was given no opportunity to secure a knowledge of the fundamental principles and uses of accounts.

Accounts play such an important part in both professional and business transactions that the man who lacks all knowledge of accountancy is seriously handicapped as compared with the man who has gained some familiarity with the subject.

Accountancy literature and schools in a measure have relieved the situation. I do not under-rate the value of theory. I believe in schools of commerce, accounts and finance. In accountancy theory has a well defined place, and the professional auditor who is unacquainted with all the developments of the science as improved and published by the other members of his profession will find himself as far behind the times as the physician would be who stopped purchasing medical books and reading medical periodicals. But no one careful of his health will consult a doctor who has not had the practical training which comes only from direct study of living patients. The logical inference is that accountancy students need the equivalent of a clinic as well as experience such as the medical student's term of service as a hospital "interne."

The proof of this need lies in the unsatisfactory results at the present time. Admitting all the advantages of and necessity for theoretical training we find that it is far from being sufficient. The deficiency universally recognized by instructors in accountancy schools, certified public accountant examiners and public accountants is loosely described as lack of practical experience. Now if practical experience means a given number of years' clerkship in an office (other than that of a public accountant) we, to a certain extent, contradict our claim that accountancy

is a science. If its principles can be acquired and assimilated only by contact, as is the case with bricklaying, it would be very discouraging to attempt to short-cut the process of training students.

The discouraging features of the situation should not be minimized, however. As heretofore stated, it is a sad fact that most of the applicants for the certified public accountant degree have failed to pass in practical accounting, and it is equally lamentable that most professional and business men cannot recognize nor discuss elementary questions of accounts.

Is it not because the student cannot and the others will not work among the records of *actual transactions*? We know that our physician has had experience with living subjects. We know, too, that the accountancy student has struggled with theoretical problems, most of which lack the atmosphere of reality and which at the best are poor makeshifts. Even this, however, is better than the experience of the business man who does not even have the opportunity to struggle with the problems.

With some diffidence I suggest as a solution the establishment of an accountancy laboratory in connection with each school of commerce, accounts and finance, and wherever these schools are connected with colleges and universities laboratory work should be a part of the general curriculum. Of course law students and others who do not propose to practise accountancy as a profession would not spend more than two or three hours a week in the laboratory, but I feel that this limited time, during perhaps the junior and senior years, would be of equal or greater value than the studies which it might displace.

The chief value of college education is to train the mind—the mental faculties. I know of no better study than that of recorded events, the analysis and restatement of which require all of the mental energies which the average man possesses. It is impossible to estimate the tangible value which a fair knowledge of accounts thus acquired will have to the busy man of affairs. We have only to listen to the regrets of those who lack this knowledge to estimate its undoubted advantages. If the laboratory will be of value to the general student it will be of far greater value to the accountancy student. I think it will in a great measure supply the deficiency which now exists. It is my thought that the laboratory will contain many complete sets

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of books, which have been used to record the transactions of business enterprises which have been discontinued by dissolution or bankruptcy. I am assured that these sets of books can be secured in considerable numbers. The account books of most bankrupt concerns are in bad shape and this will add to their value as laboratory material.

The student who can be *shown*, intelligently, how a thing should *not* be done will have a better grasp of erroneous entries than to have it explained without illustrative material to visualize the error.

Business schools which require books of account to be written up, currency and cheques to be exchanged and furnish other facilities such as may be found in business concerns, have done and are doing valuable work — much more valuable than where text books only are used. The disadvantage and insufficiency of such a system is that each student sees what the other sees, the transactions to be recorded are hypothetical and before serious errors are made the student's work is corrected.

My thought is to have available a few complete model sets of books, and to have other sets incomplete on which the students can work under competent supervision. These sets will embrace various lines of business so that a student who expects to occupy an executive position in a mercantile house, and whose training after leaving college will be in the sales division of the business rather than in the accounting department, will have an opportunity to see and have explained to him a model set of mercantile books, and will also have explained to him the inaccuracies and insufficiency of actual sets of mercantile books, where the proprietors have been unsuccessful.

A considerable proportion of failures is directly due to bad bookkeeping, and the bad bookkeeping is almost invariably due to ignorance. Therefore an opportunity to see how books should be kept and how they should not be kept may transform a student's whole future career.

Lawyers rarely understand accounts. This is not strange as their training does not include the study of accounts. It is not their fault. No provision is now made for the study of the science of accounts during their college career, and the subsequent facilities for securing such knowledge do not, of course, appeal to them.

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Most lawyers take civil cases only, but a vast number of civil cases relate to disputed accounts. Furthermore, a lawyer should know how his own account books should be kept. Usually he handles trust funds and the proper record of fiduciary transactions is most important. Ignorance and neglect of proper accounting methods by lawyers have cost them and their clients unbelievable sums.

It is my thought that the work must be made attractive and interesting. It must be developed logically and without some of the technical verbiage with which accountancy has been unnecessarily clothed in the past.

I would have prepared a model set of books for a lawyer's office, showing the best and most efficient system for recording charges to clients and the segregation of trust funds. I would have blank forms which law students would be required to fill out. I would have a few sets of books prepared showing how losses and annoyances arise through incomplete and inaccurate records. Subject to change upon further investigation, I believe that if a law student were to spend one or two hours a week in the accountancy laboratory during the last few years at college and law school, he would acquire a creditable and workable knowledge of the accounts peculiar to a lawyer's office as well as a general familiarity with mercantile and financial accounts.

In addition to the usual books of account I would have on exhibition and for demonstration collateral records such as minute books of corporations, stock certificate books, transfer books and many others in general use. I would have on file annual reports and other statistical data from the leading concerns in every line of business, together with charts and organization forms, descriptions of systems in use, etc. The analyses of these reports and systems should be preserved and it might be feasible to distribute to those interested the more important compilations.

I would also have on exhibition and for demonstration office appliances. Today much of the work of bookkeeping is done by mechanical methods and as a large proportion of college students never have a chance subsequently to see or hear about these appliances they should have such an opportunity before they leave college.

An Accountancy Laboratory

An accountancy laboratory is now being installed at Columbia University. Of course it will take years to equip such a laboratory, even modestly, and it will cost a lot of money and involve immense labor. It is part of my present plan to use the students in the advanced accounting courses to assist as much as possible with the material now being secured. I hope some friend of the university who is interested in the scheme will give some money. If one laboratory works well others will follow but it would not be worth while for any one else to adopt my suggestion until substantial progress is made. The plan may be a failure or it may succeed, but it would be well to await the outcome of one test before entering upon others.

As it is my purpose to disclose fully to any one interested all of the advantages and disadvantages which develop from time to time, and to put in permanent form suggestions as to what to do and what not to do, I trust that any one who reads this and who can give me, or get for me, old or new account books or records, or financial reports or anything which should be in an accountancy laboratory, or who will send me any constructive suggestions will do so for the good of the cause. I would like to build fast in order that a good test may be made soon.

Uniform Systems of Accounts for Public Utilities*

BY CARL H. NAU, C. P. A.

The law of Ohio, creating the public utilities commission, in effect August 9, 1913, empowers the commission to prescribe uniform systems of accounts to be kept by all public utilities or railroads, including municipally owned or operated utilities; to classify said public utilities or railroads, and to establish a system for each class; to prescribe, further, the manner in which these accounts shall be kept. Said accounts, when practicable, shall conform to those required by the tax commission of Ohio, and shall conform, as near as may be, to those prescribed by the interstate commerce commission for utilities coming under the jurisdiction of the federal commission.

The apparent reason for this latter proviso is that, as the interstate commerce commission has jurisdiction over interstate business, and as many corporations do both a local and interstate business, it would cause unnecessary inconvenience to require a corporation to keep its accounts in two ways—one according to the orders of the interstate commerce commission and the other according to the requirements of the public utilities commission.

The power to establish uniform systems naturally includes not merely the enumeration of the titles of the accounts, but also specific provision as to the method of keeping these accounts, the definition of terms used, and a statement of how various items shall be debited and credited.

The law also provides that when the commission has prescribed the form of accounts, records and memoranda, it shall be unlawful to keep any other accounts excepting such as shall be explanatory of, and supplemental to, the accounts so prescribed. The commission has access to all books of account and records, and may designate its officers and employees to inspect and examine any and all accounts.

We expect that the preparation of these uniform systems will take some time, but the importance of establishing systems that

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will be elastic, so as to meet all the varying conditions of business, is so apparent that it behooves us to make haste slowly. We wish to take advantage of everything that has been done by other state commissions and by the federal commission, to the end that we may be as consistent as possible, and not deserve the questionable compliment of making burdensome requirements, just because we have the power to do so.

It is, of course, our intention to set up a scheme of accounts for each public utility; each scheme to be sub-divided into classes, so as not to require the small company, with limited means and few employees — each of whom may perform several functions — to keep the same accounts that are required of a big corporation, with large expenses under each heading, and with an organization permitting a minute differentiation of functions.

The corporations, operating each different utility, will be grouped into classes according to the magnitude of their operations. This will establish uniformity and permit trustworthy, comparative statistics to be made, and, at the same time, preserve the flexibility, which is so essential.

The desirability of uniform accounts as a basis for uniform reports has in recent years been recognized by an ever-increasing number of accountants, economists, governmental officials, and the public in general. Past experience demonstrates, however, that if this uniformity is ever to be attained, it must be accompanied by a common language of accounts; by the universal use of common terms with the same significance.

I shall take it for granted that, theoretically at least, we are all in favor of standard and uniform reports from not only all public utilities but from all municipal enterprises, and, in fact, from the municipalities themselves; that we appreciate the necessity for such reports, and that we earnestly desire to see standard schedules authoritatively provided. Accepting this position, we may then address ourselves immediately to the practical difficulties, which this programme involves, and the question arises: "What obstacles must we first overcome before such standards can be provided?"

To answer this question properly involves the statement of the whole scheme of accounting. In the first place, schedules and schemes of uniform accounts should be accompanied by a care-

fully developed nomenclature, and all the terms employed should be strictly defined.

In applying the science of accounting as an aid to the successful administration of a business or enterprise for gain, two principal classes of accounts are always employed; namely, one group of accounts known as "balance sheet accounts" and another group known as "revenue and expense accounts."

In addition to these two principal classes of accounts, most enterprises, doing any considerable amount of business, keep additional, or supplemental, accounts of a more or less statistical nature, to aid in furnishing the information needed for their systematic and scientific administration.

Balance Sheet Accounts:

The balance sheet accounts are those ledger accounts in which are kept —

- (1) A record of the wealth in the possession or control of the company;
- (2) The claims of its creditors and trust beneficiaries, and
- (3) The equities of its proprietors or owners in the wealth possessed or controlled by the corporation.

They are the accounts which, when properly summed up in a statement called a "balance sheet," will present a correct exhibit of the financial status of the enterprise at a specific time.

These accounts are by some accountants called "indicant accounts."

I shall have something more to say, later on, as to three elements of the balance sheet, namely: assets, liabilities, and proprietorship.

Revenue and Expense Accounts:

These accounts are those ledger accounts in which are recorded the amounts that *accrue* as revenues, and the amounts that are *incurred* as expenses, as a result of the operation of the enterprise. They are the accounts which, when properly summed up in an "income and profit and loss account," disclose the result, or outcome, of the business for a given period of time.

Any system should, therefore, clearly and accurately classify the specific source of all income and logically and consistently classify the specific purpose of all the expenses.

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Prerequisites for Successful Systems of Uniform Accounts:

The annual revenues of the different public utility enterprises in this state vary so greatly that logically the number of accounts that shall be required, or that could be used to advantage, must necessarily vary with the volume of business and with the magnitude of the enterprise. Hence, the uniform system of accounts, which the commission has in mind, will be first of an elastic character and adjustable to the requirements of large and small enterprises, and to that end will have the following special characteristics:

(1) The financial data must be so classified, and the accounts so arranged, that they will provide summaries of results or conditions, along the same fixed lines and upon the same bases, so that comparisons can be made between the summaries of different fiscal periods and between those for similar enterprises, whether they be small and comparatively simple or very large and complex.

(2) The accounts must so divide and sub-divide expenses as to disclose the three elements which make up the total cost of service, *viz.*:

(a) The demand cost

(b) The customers' cost

(c) The consumption cost; and, in turn, again separate these costs into those that are "fixed" and those that are "variable," so that from the data it will be possible to determine the equity and wisdom of existing rates for services, and also to make possible a revision of incorrect rates for such services.

(3) The accounts must be so designed and designated as to make the system readily understood, and thus easy of application.

Groups and Orders of Accounts:

To meet the requirements, as stated, the accounts of this uniform system should be arranged in different groups, sub-groups, classes, sub-classes, and minor divisions, and must, therefore, be of several orders — each order and each account bearing a definite relation to all the others.

The uniform system should also be devised in such a way that the number and kind of accounts employed may be adapted

to the individual requirements of each enterprise, while at the same time providing accounting data of a uniform and comparable character.

The decimal system of notation for designating the various accounts will probably be used, which used in connection with capital and small letters of the alphabet lends itself to practically unlimited expansion.

Elements of the Balance Sheet:

Referring again to the balance sheet — I think that no one will fail to note the distinction between an asset which you own and a liability which you owe. Now, the excess of what we own over and above what we owe measures the "proprietorship."

In accounting the proprietorship or the proprietary interests are the property rights or equity of the stockholders, owners and others who constitute the proprietors of the business or enterprise, in the assets or wealth belonging to, or employed in or by, the business or enterprise.

In a sole proprietorship this element is usually carried in one account called "net worth"; in a partnership each partner's net worth is set forth in an account bearing his name; but, in a corporation, it is made up of the capital stock, surplus and the various reserves which have been especially ear-marked and set aside out of surplus.

Universally in the past it has been and for the most part it is still the practice of a great majority of accountants to list these proprietorship accounts in the balance sheets and ledgers as liabilities; and many writers on accounting have endeavored to explain how these interests *are* liabilities of the business or corporation, not to outside creditors, but to the owners. But economists have pointed out the great difference between proprietary interests and liabilities, which is really fundamental to a proper statement of the assets and liabilities. This whole matter may be summed up and stated very concisely by saying that proprietary interests are "rights in," while liabilities are "claims upon" the assets of a business or enterprise.

Our best modern authority for this treatment of the balance sheet accounts with credit balances is PROFESSOR CHAS. E. SPRAGUE, who, while a master of arts and a doctor of philosophy, as well as a certified public accountant, was also a very prac-

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tical business man, and was for many years the president of the Union Dime Savings Bank of New York.

We also hope to set up the accounts covering the much mooted question of depreciation and reserve for depreciation, so that the interests of the enterprise and of the commission, which represents the state of Ohio and its people, may be reconciled.

At present, I desire to enunciate broad principles, rather than to go into the refinement of accounts, which after all is a mere matter of detail and bookkeeping procedures, after we have laid a sound foundation of principles.

Elements of the Income Account:

Referring, now, to the income account — the excess of the total income from all sources over the expenses of all kinds is the net profit for the fiscal period. The only disposition to be made of this is to transfer it to an "undivided profits" account, usually called "surplus"; against which is then charged the disposition of the net income, in the way of dividends paid or transfers to specially ear-marked reserve accounts.

Now, the income is received, first, from operating revenues, against the total of which are set up the operating expenses. It seems to me that the most of our immediate work lies in the proper allocation of the expenses incurred in securing a certain operating income; and here again I wish to suggest some general, broad principles which underlie the operations of any and every public utility.

In point of time, the first step taken by any utility is to spend money for a plant, for land, buildings and equipment, and as soon as these are installed and operations are commenced money must be spent in the maintenance of these buildings and equipment.

The elements of maintenance expense are superintendence, labor, material and other miscellaneous expenses. By means of analysis these charges can be applied directly to any unit or portion of plant, no matter where located.

Of course, building a plant and maintaining it in working order will not produce any revenue. The plant must be operated; so our next great division of expenses is operation; and the elements for this are almost the same as for maintenance, except that the labor and material can be sub-divided into various classes,

according to the specific functional character of the expense. Operation can also, by means of analysis, be allocated directly to the plant or unit where the work is performed.

But, even while maintaining an operative plant in good working order, there is constantly something happening to the plant, under our very eyes, and yet its action is so slow that we do not notice it until forced to by the demands for renewals and replacements.

This much discussed, and little understood, action is depreciation, which is caused by, and is composed of, the following three elements:

- (A) Wear and tear
- (B) Obsolescence and inadequacy
- (C) Accidental breakage

and it is overcome by the following:

- (X) Repairs
- (Y) Renewals and replacements
- (Z) Betterments

If the sum of (X), (Y) and (Z) is more than the sum of (A), (B) and (C), for a fiscal period, then the assets are worth more than at the beginning, and there will be no need of charging anything for depreciation. But, because of the fact that frequently replacements and usually betterments have been charged to an assets account, instead of to an expense account, and no depreciation or inadequate depreciation has been set up, the result has often been payment of dividends out of capital and, eventually, bankruptcy and reorganization.

Whether or not depreciation can be allocated to the various units of investment, and tied into the cost of operation at different points, depends upon the condition of the books of account of each individual enterprise. If the assets of buildings and equipment cannot be analyzed so as to set out the different classes of units, their respective age, original cost, (or reproduction cost with depreciated value to date), realizable junk value, etc., so that some really intelligent percentages can be applied, then the only feasible plan is to use rough estimates for a few years, until the property can be appraised, either privately or by the commission, when a complete scheme of depreciation accounting can be applied.

These three, then, maintenance, operation and depreciation,

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will ultimately be so analyzed as to allocate each portion of this expense against the unit of production or transmission, as the case may be.

General Expenses and Fixed Charges:

General expense, taxes and interest are in the nature of general overhead, and while they are a direct charge against revenue or income, it is not expected to distribute these directly against the revenue producing factors, unless they cover a variety of plants, such as an electric light and power, railway and gas plant all operated by the same company. In that event, some arbitrary method must be devised, based upon the ratio that the expenses of each plant bear to the company's whole expense, or upon some other basis of allocation, which a study of the problem might show to be an equitable one.

Let it be understood at this point that revenue includes all revenue accrued or earned during the fiscal period, whether the same be collected or not. That is to say: all income earned to the end of the fiscal period must be credited to some revenue account and charged to an account receivable.

Likewise the term expense includes all expenses incurred, whether the same have been paid or not; i.e., everything used in making the income for the period must be charged up as an expense and credited to some liability account, being especially careful to see that anything taken into inventory has been credited to the proper liability account in the books.

Fiscal Dates:

As to fiscal dates, I believe that, with proper attention paid to accruals and prepayments and a workable scheme of perpetual inventory accounts, very close approximations can be made in the monthly reports of the income and expense and of the financial standing, so that any fiscal date chosen can be easily fitted into the corporation's accounting. These monthly reports can be adjusted by an actual physical inventory, semi-annually, say at June 30th and December 31st. I, personally, feel that no concern should allow twelve months to pass before making a "clean up," and then possibly have to wait two or three months more for figures. With modern accounting procedures these re-

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sults can be very closely approximated monthly and corrected absolutely at the end of each six months period.

The books need not necessarily be closed oftener than once a year.

There are so many different fiscal dates that it is almost presuming too much to expect all the various authorities to agree. An effort will be made, however, to have the tax commission and the public utilities commission agree on fiscal dates and financial statements required to be furnished each of the commissions by all public utilities, so that the adjusting of the books to the statements will be reduced to a minimum.

The records should be designed in accordance with the required statement classifications so that the information may serve its purpose substantially as it is automatically collected upon the books, and thus avoid the unnecessary work of a re-analysis.

Finally, as before stated, for the sake of economy and consistency the commission's requirements as to accounting, reports, etc. will follow in the main the requirements of the federal government for corporations subject to federal regulation by the interstate commerce commission.

Benefits of Uniform Accounting:

The results of the creation of such a system will be beneficial to the public, to the corporation manager, to the prospective investor and to the present holders of stocks and bonds.

There is the consumer, who is anxious to know whether he is being charged more or less than a reasonable price for the service rendered, and whether the charges ought to be decreased or increased, in view of the actual cost of operation and a fair return upon the investment. It may be that he prefers improved service. The facts must be known in order to determine whether it is reasonable for him to demand it at existing rates, or whether an increased charge will be necessary.

The tax payer desires to know whether the corporations are bearing their proper share of the burdens of government and whether the taxes paid may reasonably be increased or decreased.

The prospective investor is interested because he will be able to determine whether he may wisely invest. He is entitled to know the facts; and without a proper system of accounts he can

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only surmise or guess what the actual situation is. If he does not have the facts, his surmise may or may not prove correct, and the uncertainty thereby introduced not only tends to prevent the genuine investor from putting money into the securities of public service corporations, but makes it difficult for these corporations to secure the funds with which to develop their undertaking.

Further, the efficient and progressive corporation is apt to be classed with the non-efficient and badly managed corporation. The former suffers because of the misdeeds of the latter, and the latter tries to rise upon the record of the former—a condition which is injurious to both the investing and the general public and unjust to all concerned.

It goes without saying that the present bond and stockholders having put their money into the enterprise are entitled to know the results of operation, and the actual status of the company in all details. It is hardly conceivable that any one would dispute this assertion; but it is a fact that not infrequently the holders of securities have been kept in the dark and ignorant of important matters affecting their own company.

If there is mismanagement or improper use of corporate funds, how can stockholders punish the guilty unless they know of it? On the other hand, how can they reward efficient management or distinguish efficiency from inefficiency, unless there are accurate reports revealing facts?

In order to show accurately the actual conditions, so far as they can be presented through the science and art of accountancy, income and expense should be subdivided so as to show each source of revenue and the amounts received from each source, and the purpose of each expenditure and the amount so spent. Of course, this does not mean that a system of accounts should show every voucher that is drawn, but there should be such a classification of vouchers as to separate each expense from others that are not of the same character.

This will be sought in the systems to be adopted, so that it will be possible in the future to analyze expenses and to show the cost of performing each separate and distinct function. It is only through such a system that the operating man himself is able to discern whether there is unnecessary waste or greater economy can be secured by more attention to special features.

Uniform accounting would not reach the desired result if it were not possible to carry comparison beyond the chief items and into an analysis of the details which go to make up the main rubrics.

Under a proper system it will be possible not only to compare the results obtained by the various companies throughout Ohio, but also, perhaps, to compare with other states, thereby stimulating efficient and economical operation.

Another purpose of uniform accounting is to state the fundamental principles according to which accounts should be kept so as to prevent the charging of items to wrong accounts. This problem would be simple if all moneys expended within a fiscal period were for labor or materials which were fully utilized or consumed during that period, and which were not carried over in any degree for use in a following period. But in practically every case there is some plant that lasts more than one year, the cost of which must not be wholly charged against the service rendered in a single year.

From this fact arises the difficult problem of framing a system which shall secure in each year's accounts the inclusion of the proper portion of the fixed capital or fixed assets consumed during that year.

The danger upon the one hand is that a sufficient amount will not be expended or set aside to keep the property of the company up to the proper standard. Sometimes rates are too low, but more often the straining for big dividends leads to the setting up of a large book profit by neglecting repairs, renewals or provisions for depreciation. The virtual effect of such a policy is to hand each stockholder, year by year, a small portion of the plant in the shape of dividends.

Even the common method of including the cost of repairs and upkeep of the productive plant in operating expense for the year in which the money was actually spent is objectionable, for it allows the managers of the enterprise to put either more or less money into maintenance, and thus overstate or understate true costs at will. Even under conscientious management operating costs would vary from year to year according to the amount of reconstruction necessary.

The other danger, of which there has been less experience so far, is that an undue amount will be taken out of earnings

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and spent upon the plant, usually in the form of additions to plant. In this case, provided capital receives a fair return, it is the user who suffers, for he has been taxed without his leave to provide capital for the undertaking and without receiving in return either stocks or bonds.

To guard against this possible overstatement of the operating costs, it is necessary to provide that extensions and improvements of the plant shall be charged to an asset account and not to an expense account. Unless such additions to the assets are shown in the fixed assets, their value would be carried as a secret reserve until some opportune time for their distribution in the form of stock dividends, or in the form of extra cash dividends, the funds for which have been meanwhile secured from the sale of stocks or bonds to offset the first cost of the additions to plant which were made out of earnings. Even if neither of these methods is allowed the charging of additions to income is improper, because thereby costs are abnormally inflated and the public is led to believe that profits are not sufficient to warrant better service or a reduction in rates.

Furthermore, the existence of this secret reserve is an inducement for the manipulator to come in; it is an attractive prize, if he can only reach it without running foul of the law in so doing.

All of the foregoing is intended to show that the primary purpose of a uniform system of accounts is to ensure the integrity of capital and the correctness of the charges to costs of operations. This term "cost" is used here in a general sense as meaning all costs incurred, whether for maintenance, operation or depreciation.

Depreciation Scheme

Public utilities should be required to ascertain the life or term of service of their fixed assets, and to include in the operating costs of each period a sufficient allowance to cover that part of the life of the productive plant which has expired during the year. The deterioration that has taken place during the year, at times may be no greater than the expenditures for repairs and renewals (and included in the operating expenses), in which event the operating expenses afford a true statement of the real cost of service rendered. But plant and machinery cannot be made

to last forever by repairing. Some allowance must be made each year for the expense of eventual replacement.

The consumption of capital invested in a machine that gives ten years' service is just as much a part of the expense of operation as is the cost of materials consumed in a single day, and it would be no worse accounting to reckon profits before charging up materials consumed and labor used than to do so before meeting the cost of expired outlay on machinery and other fixed plant.

In order, then, that capital may not be impaired, a corporation must provide not only for repairs and eventual replacement, but also for depreciation due to obsolescence and inadequacy. New processes are being discovered and new machinery invented. Plants must be placed upon the scrap heap long before they are completely worn out, because they have been superseded by more efficient machinery. Cities are expanding and conditions are changing so that occasionally certain portions of the physical property have to be reconstructed, because the original plans have been outgrown and are thereby rendered useless. Central stations must be removed to new locations because urban growth has made their first location undesirable or uneconomical.

An accounting system should specifically prescribe how these factors shall be treated. In the first place, in connection with all entries in capital accounts there should be sufficient facts to identify every particular item, and the actual money cost should be given.

The next important step to be taken by the corporation (and I would advise every company to set to work on this immediately) is to determine what amount should be set aside month by month to cover wear and tear, obsolescence and inadequacy.

Every corporation ought to be required to file with the commission a copy of the rules according to which this amount is computed, together with a sworn statement of the facts and the expert opinions and estimates upon which such rules are based.

Suspense Accounts for Discounts

The corollary of the principle that asset accounts shall be charged with only actual money cost is that discounts and commissions upon securities, issued in payment of cash or other assets, shall be charged to a suspense account. Any expense in

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connection therewith should also be charged to this account. At or before the close of each fiscal period thereafter a proportion of such discount and expense, based upon the life of the security, should be credited to this account and charged to an amortization account, which in turn, should be closed out against the current fiscal year's income.

The amounts thus set aside should be sufficient to amortize the discounts, etc., by the time the debt matures.

Capitalization of Franchises

Another important requirement, which carries out the statutory provisions as well, is that the account *Franchises* shall be charged only with the amount actually paid the state or political subdivision thereof in return for the granting of franchise rights and with the legitimate expenses incident to procuring such franchise rights. This should be exclusive of any taxes or other annual charge and these amounts of intangible capital value should likewise be amortized during the life of the grant.

Effect of Requirements:

The effect of these requirements is that every charge to an asset account must represent one hundred cents on the dollar in money actually spent in creating the property of the corporation. When \$100.00 of par value of bonds is exchanged for \$75.00 of cash, to be spent for fixed plant, there is obviously no propriety in charging the fixed asset account with \$100.00 to be carried there permanently.

The far-reaching effect of establishing such broad, fundamental principles can hardly be overestimated. The investor will be given a guarantee that he has never had before, because one of the things which have worried him most has been the fear that the capital of the company would be impaired and his investment be rendered of little value. No system of accounts that can be devised will absolutely prevent impairment, but a well devised system will go a great way in that direction, and it will certainly keep the amount of actual impairment under safe control.

The removal of such risks will not only attract capital but will lead to the obtaining of capital at a lower rate. When an investor himself must provide against depreciation and impairment out of his interest or dividends, he naturally demands a higher

rate of return than if he knows of a certainty that the corporation itself has already made ample provision. This inures to the benefit of the public as well.

Treatment of Appreciation

Under correct accounting principles appreciation in the value of property is no off-set to depreciation. The policy adopted by many public service corporations of depending upon the increase in the value of their assets, consequent upon community growth or changes in market values, is not recognized as proper.

Ultimately, of course, the accounts will reflect these facts. The fundamental principle, however, is that any appreciation shall not appear in the accounts until it is an actuality, *viz.*, when the amount of appreciation has been clearly determined. It should then be shown as such and not buried in the making of depreciation charges.

In conclusion I desire to say that it is my hope that the commission, with its uniform accounting systems based upon the best modern practice, will prove to be a real blessing to the utilities themselves, although it may possibly appear to some of them quite the opposite at this time.

It has always seemed to me that the much to be regretted situation in which so-called "big business" and Uncle Sam find themselves today could have been entirely avoided by the adoption of a policy of honest publicity, *i.e.*, by the corporation taking the public into its confidence and dealing fairly with it. Speaking entirely unofficially, I personally feel that the people do not want confiscation; on the contrary all they want is a fair deal—fair to the consumer and fair to the utility. What would be absolute equity can only be approximated more or less closely as the accounting records themselves disclose the truth. I believe that the only way in which the corporate history of any public utility undertaking can be properly recorded, codified, analyzed and summarized is by means of a uniform system of accounting, built on the broad principles the commission has in mind and which briefly, I have attempted to describe.

Treatment of the Returnable Package in Accounts

BY G. V. W. LYMAN, C. P. A. (LA.)

The treatment of the returnable package in accounts is a subject on which I have found a wide difference of opinion, and I believe its discussion would be of benefit to accountants in general.

The importance of proper records for the returnable package exists in many lines of commerce, but notably in the mineral water, liquor and cracker businesses. The account presents four distinct features:

1. There is the liability to the customer for the return to him of the amount charged for the package, when it is billed out to him with merchandise contained therein.
2. There is the asset of the actual value of the package in the hands of the customer to be returned.
3. There is the loss or expense of maintenance of the package, and the loss from wear and breakage or the value of the packages worn out and discarded or dumped.
4. There is the element of profit on those packages which are never returned but are broken or retained by the consumer.

Taking these in the order named, we have first the liability to customers. This is very important. In my experience, I know of one large factory that was forced to the wall by the redemption of returnable packages during a panic. The records did not include this liability and the company was unprepared to meet the sudden call for the redemption of outstanding obligations of this character, which the tightness of money caused people to look up and convert into cash.

In order to handle this item properly it is necessary to start at the time the package is billed out to the customer, (see form 1 at end of this article) and separate it from the merchandise therein. From the sales sheet it is posted to the customers' or sales ledger (form 2) and it is so recorded there that one may at any time ascertain at a glance whether the customer is indebted for merchandise or owes for returnable packages.

The next step is the credit memo. covering the return of these packages (form 3) which, like the sales sheet, is posted direct to the customers' or sales ledgers. The total of packages charged to customers is credited monthly to outstanding return-

able package account in the general ledger, and this account is charged monthly with the packages redeemed both from the total of the column in the cash book for those paid for in cash and the total of the credit memos for those credited through these records. The difference in the outstanding returnable package account, if handled in this manner, will at all times show the amount, in dollars and cents, of packages outstanding.

The keeping of the returnable package separate from the merchandise is important, not only for proper accounting and to ascertain the true condition of accounts receivable, but it is also important in arriving at proper commissions due salesmen, as no factory or business can properly pay a commission on that part of the sales which nets them no profit and is only a necessary expense in their operation.

The second factor is the asset consisting of the value of the package to be redeemed.

As in almost every case where a returnable container is used in trade the price charged for the container exceeds its actual cost, this asset cannot equal the amount charged. In many cases the original cost is not more than sixty or seventy per cent of the charge and its value as an asset is less than its original cost, for by use it has become second-hand and requires expense in labor and often in material before it can again be fit for use. Therefore when considering these outstanding packages as an asset, they can only be properly so taken at a value not to exceed their cash second-hand worth if returned and in stock. This asset only appears on the books, of course, at inventory periods, and is handled as shown later.

The third question is maintenance or loss.

The cost of maintenance is handled as would be any other expense account in the records and is covered by an account known as maintenance of returnable packages. This includes all labor and material used in cleaning or repairing and preparing returned containers for use, but does not cover the value of containers discarded or dumped. Worn out or discarded containers are charged to profit and loss and credited to returnable packages account.

It will be noted that I here introduce a new account, "returnable packages account." This account has nothing to do with the account known as "outstanding returnable packages,"

Treatment of the Returnable Package in Accounts

mentioned above. Returnable packages account is started with the inventory of packages on hand in the factory or warehouse and the inventory of the actual value of returnable packages in the hands of customers. To this account is charged during the year the purchases (at cost) of new containers. It is credited with containers discarded or dumped. In other words, the returnable package account is the asset account and the outstanding returnable packages account is the liability account. These two, with the maintenance of returnable packages account, complete the accounting record of the returnable package in all cases where the container is charged for as a part of the selling price of the merchandise; but they do not in any way cover the method necessary or desirable where the value of the container is not included in the selling price or repurchased by the manufacturer, but is simply kept track of and collected by the distributor, as is the case in a few branches of trade.

This now brings us to the fourth and last element, that of profit on containers broken or retained by the consumer.

While this profit does undoubtedly exist, the determination of its exact amount is extremely difficult, if not impossible, and the only practical method is to determine by experience the percentage of the containers sold which are never returned, but are paid for by customers and whose age precludes their being returned for credit. In arriving at this percentage, care should be used to be conservative in order that the liability may not be reduced below its real amount. Once ascertained, this profit is credited to profit and loss and charged to outstanding returnable packages account; but this must be done, of course, before the inventory of containers in hands of customers is made up, as that also is calculated on a percentage basis and governed by the balance shown on the outstanding returnable package account.

There is another important feature in the proper handling of returnable packages which I have not discussed and that is the relation to accounts receivable. Unless form 2 or something similar is used for a customers' or sales ledger, it will be very difficult to separate the real asset in the accounts receivable from the amount due for returnable packages, and in certifying to the statement the accountant is likely to deceive the banker or stockholder who receives his report as to the real condition of the business under examination, and thereby not only to hurt his own reputation, but to injure the profession as a whole.

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I should like to see this subject discussed by others in **THE JOURNAL OF ACCOUNTANCY**, and trust this article will provoke a discussion.

Heading to be in usual form for sales sheets.

| Date | Articles | Mdse. | Pkgs. | Total |
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Form No. 1, Sales Sheet, size to be made to suit business.

Heading to be in usual form for sales ledger sheets.

DEBIT

CREDIT

| Date | Mdse. | Pkgs. | Total | Total | Mdse. | Pkgs. | Date |
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Form No. 2, Customers' Ledger, size to be made to suit business.

Heading to be in usual form for credit memos.

| Date | Articles | Mdse. | Pkgs. | Total |
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Form No. 3, Credit Memos., size to be made to suit business.

Theory and Practice

BY ALLAN W. WRIGHT

"The importance of principle is to be emphasized throughout. In simpler situations a shrewd empirical tact suffices; in complex ones sound practice is more and more dependent on sound theory. Knowledge of principles is necessary to offset the limitations of experience and the narrowness of interests; the corrective of application is needed to make principles real and vital." ¹

In these words PROFESSOR JASTROW states a principle that may be followed with profit by every accountant who desires eminence and success.

The words theory and theater come from the same Greek root. A theater is "a place for seeing." In Greek theaters the spectators sat on the slope of a hill, where they could look down upon the play.

The word theory, which has been defined to be an organic development of the relations between the parts of any systematic whole, carries the same idea of things seen in the large, as from an elevated and detached viewpoint. If one could be suspended above a city, he would lose sight of small things, but would be able to form a perfect theory of its design. Its boundaries by field and water, its grand divisions, its dissevering streams and boulevards and arteries of traffic, its parks and monumental buildings would stand out in bold relief, and the relations of parts to parts would be clearly seen.

Similarly the decisive outlines and outstanding importances tend to emerge in the regions of knowledge as one rises to a superior and comprehensive vision. Fundamental laws and doctrines appear. Frameworks of principle, upon which practices are moulded and by which they may be explained, are discerned, while details sink to the levels of their relative importance.

"Shrewd, empirical tact!" How blind to his chief means of progress is the accountant who depends upon shrewd tact! He feels his way as one in the dark. Finding an office poorly or-

¹ Introduction by JOSEPH JASTROW, head of the department of psychology in the university of Wisconsin, to *Psychology in Daily Life*, by CARL EMIL SEASHORE, professor of psychology in the state university of Iowa.

ganized, he experiments here, adventures there, tries this device, that expedient and the other procedure, until by slow, laborious and costly experience an organization of more or less efficiency is developed. He confines himself to applying the results of his own observation, and gropes his way. It is such as he that would put cashiers in charge of customers' ledgers.

A wiser man realizes that sound practice is dependent upon sound theory. He avails himself of the deep insight which science gives. He applies the theory evolved from the experimentations of other men. To him theory is a torch that casts upon practice the illumination of principle.

The illustrious German strategist, VON MOLTKE, recognized the dependence of sound practice upon sound theory. As early as 1857 he foresaw the Franco-Prussian war of 1870. In anticipation of it he constructed plan after plan; that is, he theorized upon the subject of war between France and Prussia. With the fundamental elements of the situation before his mind, the German armies, arms and equipment, transport facilities, means of subsistence, the geographical and climatic conditions, the rules of the art of war, and the resources and probable movements of the French, he continuously revised and perfected his theory for thirteen years.

In accounting, as the complexities of our civilization and commercial machinery increase, the importance of sound theory increases. The experimentation that may be permissible in the corner grocery will not do for the great company with many, far-flung offices. The issues are too grave to be left to the chance findings of empiricism.

Knowledge of principles, or theory, is necessary to offset the limitations of experience, or practice, and practice is necessary to vitalize, correct and confirm theory. This statement by PROFESSOR JASTROW has been expressed by another writer as follows: "Theory, without practice to test it, to verify it, to correct it, is idle speculation; but practice, without theory to animate it, is mere mechanism. In every art and business, theory is the soul and practice the body."

It is interesting to note that this interdependence and reaction between theory and phenomena, or practice, is to be observed in the progress of all knowledge and the growth of all science. First the slow and unconscious observation by primitive races of men

Theory and Practice

of natural occurrences, such as the apparent movement of the heavenly bodies. Then when considerable progress had been made, questions about the meaning and causes of the phenomena and the connections between them. Next the establishment of an hypothesis to explain the phenomena. Then, from the hypothesis, as a new starting-point, another series of observations by which to test the correctness of the hypothesis. Then more of hypothesis, observation and inference, until by successive repetitions of the process we have arrived at the present state of knowledge.

From the accountant who is content to practise a method without knowing its theory, no progress is to be expected. His thoughts will never rise from the details to the principles of his work.

Progress comes to men of aspiring spirit; men who thirst after an ordered knowledge, and are not satisfied until phenomena are explained by, and resolved into, causes and reasons, principles and laws. But those who would accomplish this may not remain on the level of details, or below their level, submerged by them. They must rise above them, where a comprehensive survey is possible, where relationships can be rightly seen, and things assume their true proportions.

CAPTAIN A. T. MAHAN, the well-known naval authority, has effectively expressed this idea in the following words: ". . . first, the diligent and close study of details, by which knowledge is perfected; and, second, a certain detachment of the mind from the prejudgments and passions engendered by immediate contact, a certain remoteness, corresponding to the idea of physical distance, in virtue of which confusion and distortion of impression disappear and one is enabled not only to distinguish the decisive outlines of a scheme, but also to relegate to their true place in the scheme subordinate details, which at the moment of occurrence had made an exaggerated impression from their very nearness."

The pursuit of principles is important to the accountant because the discovery and formulation of them requires conscious effort to grasp the larger aspects of things, to take a bird's-eye view of a situation. This will enlarge his horizon, expand his powers and sharpen the edge of his discrimination.

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The accountant who strives to master the theory of his profession will do more than insure the soundness of his practice. He will form a habit of mastery. He will think his problems through, and comprehend clearly the philosophy of their solution. He will strengthen his powers of analysis. He will increase his self-confidence, initiative and resourcefulness. And who does not know that these are powerful factors in the making of success?

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EDITORIAL

Certification of Borrowers' Statements

Accountants will learn with peculiar gratification that the movement to secure cooperation of bankers in the matter of certification of borrowers' statements is gaining headway and that in one city at least definite action has been taken for the introduction of rational and business-like methods.

At a meeting of the Spokane Clearing House Association held on March 24th the following recommendation was made by a committee and passed by the meeting as a resolution:

Your committee to whom was referred the question of requiring those who seek accommodation from banking institutions to furnish statements prepared by certified public accountants, report as follows:

We recommend that, so far as possible, in the case of all firms and corporations that seek accommodation, they be requested to furnish with their individual statements reports by some recognized and reputable accountant; and that such reports shall have been made after a thorough examination and at regular periods during the two or three years previous to the time when such accommodation is sought.

We are led to report thus favorably on this question to the clearing house, believing that such statements will be equally as beneficial to the borrower as to the financial institution that may be entertaining the making of the loan to any firm, corporation or individual.

The foregoing resolution is the first definite action of which we have record of an attempt to put into force the resolution

adopted by the American Bankers' Association in 1908. to the effect that certification should be encouraged and wherever possible made obligatory. There is ample evidence of a general desire on the part of bankers to introduce a system which is of advantage to all parties concerned and it is somewhat remarkable that in spite of this general recognition of the need for certification nothing of a practical nature was done prior to the action taken by the Spokane Clearing House Association.

Most of our readers are familiar with a book published by the American Association of Public Accountants last year in which the opinions of approximately eight hundred and fifty bankers were given, almost all of which were in favor of requesting that borrowers and note brokers present statements certified by public accountants. What has now been done in Spokane is merely putting into effect an idea which is almost universally approved.

It may be said that bankers as a whole having been convinced of the necessity for certified statements the only thing yet needful for a general adoption of the principle is a public knowledge of the advantages to be derived therefrom. If the public could be brought to know and admit the truth that a thorough and periodical examination of condition by an independent investigator invariably leads to better credit relations with the bank and is frequently conducive of a better understanding of actual conditions, there is no doubt that the public itself would voluntarily submit to investigation and present commercial paper to banking houses in confident expectation of more favorable treatment.

Naturally any movement so revolutionary in its nature must proceed slowly, but there is certainly no cause for discouragement. Rather is it reason for encouragement that there has been so great an advance in so few years. In time other cities will follow the example set by Spokane and what is now merely a custom of a few of the banks will become almost universal.

The action taken by the clearing house association of Spokane is noteworthy and in an economic sense most valuable.

Depreciation of Public Utilities

The relentless law of equal and opposite reaction which applies throughout the realm of physics seems to be almost as imperative in economics.

One of the most striking instances of this truth is to be found in the tendency of the public to insist upon depreciation allowance in the accounts not only of common carriers but of all public utilities as well. A few years ago the item "depreciation" (an unfortunate name) was regarded askance by the ordinary man and accountants found it difficult and in many instances were absolutely forbidden to make provision, other than through charges for replacements and renewals, for the exhaustion of the capital assets of a corporation or company in which the public had any direct interest. It was alleged that the inclusion of depreciation was merely a scheme by which to decrease the apparent profits from operation so that a few interested persons could receive a sort of secret advantage over and above the ostensible revenues derived from investment.

Now, however, a great change has come to pass and the public insists not only that there shall be depreciation but in many cases that the depreciation shall be of a fixed amount or percentage. The expression of this insistence is found in the rulings of sundry intrastate bodies of control.

Here again the accountant is confronted with a difficulty which we believe should be seriously considered. In all probability there is not one man in a thousand who is competent to determine exactly what rate of depreciation should apply in any given instance; and it is absolutely certain that no human being could fix a standard rate of depreciation for all corporations or companies even if engaged in similar activities. Any measure which attempts to fix an arbitrary rate or amount of depreciation to cover a class of assets is foredoomed to failure or at the least to produce a considerable injustice. At the present time an effort is being made in one of the great industrial states of the east to regulate the calculation of depreciation irrespective of local conditions, obsolescence, wear and tear or any of the other factors which contribute to the determination of the useful life of assets. Opposition is made to such a proposition and it is to

he hoped that there will be a modification of the suggested regulations.

We doubt exceedingly if any accountant or group of accountants, however able, would dare to express an opinion as to a general and prevailing rate of depreciation. There is no more vexed question than that of depreciation rates, and until the study of economics has advanced much further than there is any present indication that it will advance, it would be infinitely preferable that the laws, rules and regulations governing accounting as related to public service should be capable of elasticity sufficient to enable individual cases to be treated on their individual merits.

The interstate commerce commission has never yet attempted to fix a general or uniform rate of depreciation and has left it to each common carrier to determine its own rate, merely specifying that there shall be a reasonable allowance for depreciation and even this rule is limited in its application to railroad equipment only. Probably no other controlling commission is half so well qualified to determine a matter of this kind as is the interstate commerce commission, and it seems not only unwise but foolhardy for other commissions, certainly no more capable, to attempt to do what the interstate commerce commission has heretofore felt unable to do. It is eminently gratifying that the principle of depreciation has become recognized. It is an indication that the public is beginning to understand the fundamentals of sound accounting. But a note of warning is needed lest the recognition of a great principle should lead to an attempt to apply it in a manner inimical to justice and public interest.

Income Tax Department

EDITED BY JOHN B. NIVEN, C. P. A.

The rulings published by the treasury department since the last issue of *THE JOURNAL* have been almost wholly directed to the simplification of the various forms of certificates which had been prescribed hitherto for the administration of the law; and the result has been a considerable reduction in the number of forms. This issue of *THE JOURNAL* contains the modifications so far published which are as indicated below:

T. D. No. 1973 provides for the alteration of form for monthly list returns No. 1044 so that the tax withheld from interest on bonds of different classes or of more than one organization may be reported on one form.

T. D. 1974 does not strictly relate to the modification of a form but rather to the simplification of the procedure for deducting tax on interest on registered bonds. It amends the regulations so as to require that the tax will be deducted from the amount of interest due before the order itself is issued unless exemption is claimed at least five days before the due date of the interest. It further provides for an endorsement on the order thus relieving the banks of the necessity of requiring certificates of ownership.

T. D. 1976 gives revised forms of certificates to be used when presenting coupons or interest orders for collection. The ownership of bonds is now divided into four general classes, *vis.*, (1) individuals, (2) firms and organizations (3) non resident aliens and (4) fiduciaries. Where necessary in each class a form is prescribed for the case in which exemption is not claimed and another for the case in which exemption is claimed; and so that the forms may be distinguished more easily it is provided that the former shall be printed on white paper and the latter on yellow paper. Certificates by banks on the other hand are to be printed on green paper.

T. D. 1977 allows foreign banks to execute certificates of ownership in behalf of non-resident alien owners of bonds of United States corporations.

TREASURY DECISIONS

(T. D. 1973 April 21, 1914)

Revision of form 1044, monthly list return of amount of normal income tax withheld by first bank or collecting agency.

Collectors are hereby advised that form 1044, for monthly list return of amount of normal tax withheld by first bank or collecting agency, has been revised in the following particulars, so that the tax withheld from

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interest on bonds of different classes or of more than one organization can be reported thereon:

In the section of reading matter beginning, "To be made in duplicate," in the fourth line thereof, change "coupon" to "coupons," and strike out "and interest orders."

In the last line, next above the tabular list, strike out the blank lines and the words thereunder, "Describe the particular issue of bonds," and "State name and address of debtor organization."

Strike out the headings in the tabular list and substitute therefor, in separate columns, "Party presenting coupons," and immediately thereunder, in separate columns, "Name" and "Address," "Name of debtor corporation," "Name of particular issue of bonds," "Amount of income subject to tax," and "Amount of tax withheld."

Immediately after and under the line of totals of the tabular list there shall be a double rule line. Strike out the words now appearing below the total line of the tabular list on form 1044, *vis.*, "Amount of tax remitted herewith (if any) to collector," and strike out the dotted line following these words, and also the dollar mark on the same line, and strike out the double rule line appearing immediately thereunder.

Strike out all of note A appearing at the bottom of the form.

(T. D. 1974 April 21, 1914)

Change of regulations as to certificates of ownership in connection with interest orders or cheques for interest on registered bonds.

Articles 41 and 46 of the regulations are hereby amended so as to require, in the case of interest payments on bonds registered as to both principal and interest, that debtors in such cases shall deduct the normal tax of 1 per cent from accruing interest on all such bonds before sending out orders or cheques for said interest to registered owners, unless there shall be filed with said debtors, at least five days before the due date of said interest, the prescribed certificates claiming exemption.

Where such certificates are so filed the said debtors shall stamp or write on the interest orders or cheques, as the case may be, "*Exemption claimed by certificate filed with debtor.*"

Where prescribed certificates are not so filed, said debtor shall deduct and withhold the normal tax of 1 per cent from the amount of such payment, and shall stamp or write on the interest order or cheque, as the case may be, "*Income tax withheld by debtor.*"

Responsible banks, bankers, or collecting agents receiving for collection interest orders or cheques bearing the aforesaid indorsements may present said interest orders or cheques for collection without requiring that certificates of ownership be filed therewith.

Certificates of ownership are not required to accompany interest orders or cheques in payment of interest on fully registered bonds, as information as to ownership of bonds will be furnished by debtor or-

Income Tax Department

ganizations on monthly list returns, form 1012; but claim for exemption must be filed with debtors, or the tax must be withheld; and the form of certificate provided for use of owners of coupon bonds may be used by owners of registered bonds for the purpose of claiming this exemption.

Where, because of failure to file certificates claiming exemption, in compliance with above regulations, a part of the income from interest on registered bonds has been withheld for the payment of the normal income tax, debtors may, upon the filing of the proper certificates as provided in article 42, income tax regulations, to the extent of exemption claimed, release and pay to the persons entitled thereto the amount of such income so withheld.

(T. D. 1976 May 2, 1914)

Supplemental regulations prescribing revised forms of certificates of ownership, exemption, and substitute certificates in lieu of such certificates now in use.

The following certificates are prescribed in lieu of certificates now in use, and are to be used in complying with the income-tax regulations requiring the filing of certificates when presenting coupons or interest orders for collection:

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Revised Form 1000,

Ownership Certificate—*Individual*—EXEMPTION NOT CLAIMED,
shall be in the following form and shall be printed on white paper:

Form
1000.
Revised.

OWNERSHIP CERTIFICATE—INDIVIDUAL—EXEMPTION NOT CLAIMED

(To be furnished with coupons or interest orders showing ownership of bonds.)

(Give name of debtor.)

(Full description of bonds, giving name of issue and interest rate.)

....., 191.. Amount of coupon or registered interest \$.....
(Date of maturity of interest.)

I do solemnly declare that I am a citizen or resident of the United States and am the owner of the above-described bonds from which were detached the accompanying coupons, or from which I am entitled to the above-described registered interest, and that all of the information as given in this certificate is true and correct. I do not now claim exemption from having the normal tax of 1 per cent withheld from said income by the debtor at the source.

Date,, 191..

* NOTE 1.—To be filled in only when duly authorized agent executes this certificate for owner, in which case the name and address of owner must be given, and collecting agent first receiving certificate must stamp across face, "Satisfied as to identity and responsibility of agent" (giving name and address of collecting agent.)

NOTE 2.—If securities are owned jointly by several persons one may sign, and the names, addresses, and proportion of ownership of each, indorsed on the back hereof.

NOTE 3.—When numbers of bonds are required to be given, same are to be entered on back hereof.

(SIGNATURES MUST BE CLEARLY AND LEGIBLY WRITTEN.)

(Usual business signature of owner of bonds.)

(Full post-office address of owner.)

* By Agent.
(Usual business signature of agent authorized to sign for owner.)

(Full post-office address of agent.)

On the back of said certificate there shall be printed, for the use of joint owners of bonds, the following form, to wit:

JOINT OWNERS.

If securities described on other side are owned jointly, the names and addresses of owners and the proportion of ownership of each should be given.

Income Tax Department

| Names. | Full post-office address. | Proportion owned. |
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The Journal of Accountancy

Revised Form 1000 B,

Ownership Certificate—*Individual*—EXEMPTION CLAIMED,
shall be in the following form, and shall be printed on yellow paper:

Form
1000 B.
Revised.

OWNERSHIP CERTIFICATE—INDIVIDUAL—EXEMPTION CLAIMED.

(To be furnished with coupons or interest orders showing ownership
of bonds and amount of exemption claimed under paragraph C
of the Federal income-tax law.)

.....
(Give name of debtor.)

.....
(Full description of bonds, giving name of issue and interest rate.)

....., 191.. Amount of coupon or registered interest \$.....
(Date of maturity
of interest.)

Total exemption allowed under paragraph C, \$.....
Amount of exemption now claimed, \$.....

I do solemnly declare that I am a citizen or resident of the
United States and am the owner of the above-described bonds
from which were detached the accompanying coupons, or from
which I am entitled to the above-described registered interest,
and that all of the information as given in this certificate is true
and correct.

Date,, 191..

.....
(Usual business signature of
owner of bonds.)

* NOTE 1.—To be filled in only
when duly authorized agent exe-
cutes this certificate for owner,
in which case the name and ad-
dress of owner must be given,
and collecting agent first receiv-
ing certificate must stamp across
face "Satisfied as to identity and
responsibility of agent" (giving
name and address of collecting
agent.)

.....
(Full post-office address of
owner.)

NOTE 2.—If securities are
owned jointly by several persons
one may sign, and the names, ad-
dresses, and proportion of own-
ership of each indorsed on the
back hereof.

NOTE 3.—When numbers of
bonds are required to be given,
same are to be entered on back
hereof.

* By *Agent*.
(Usual business signature of
agent authorized to sign
for owner.)

.....
(Full post-office address of
agent.)

(SIGNATURES MUST BE CLEARLY AND LEGIBLY WRITTEN.)

On the back of said certificate there shall be printed, for the use of
joint owners of bonds, the following form, to wit:

Income Tax Department

JOINT OWNERS

If securities described on other side are owned jointly, the names and addresses of owners and the proportion of ownership of each should be given.

| Names. | Full post-office address. | Proportion owned. |
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Revised Form 1001,

Ownership Certificate—FIRMS AND ORGANIZATIONS,

shall be in the following form, and shall be printed on yellow paper:

Form
1001.
Revised.

OWNERSHIP CERTIFICATE—FIRMS AND ORGANIZATIONS

(Showing ownership of bonds, which is to be furnished by firms or organizations not subject to withholding of tax on interest at source.)

.....
(Give name of debtor.)

.....
(Full description of bonds, giving name of issue and interest rate.)

....., 191.. Amount of coupon or registered interest \$.
(Date of maturity of interest.)

I do solemnly declare that the firm or organization named below, and of which I am a member or an officer, is the owner of the above-described bonds from which were detached the accompanying coupons, or upon which there is due the above-described registered interest, and that under the provisions of the Income Tax Law and Regulations said interest is exempt from having the tax withheld at the source, and that all the information given herein is true and correct.

Date,, 191..
(Name of firm or organization.)

By
(Signature of person duly authorized to sign, and his official position.)

Address:
(Give full post-office address of firm or organization.)

NOTE.—When numbers of bonds are required to be given, same are to be entered on back hereof.

TREASURY DEPARTMENT,
INTERNAL REVENUE — INCOME TAX.

Income Tax Department

Revised Form 1002,

CERTIFICATE FOR USE OF FIRST BANK OR COLLECTING AGENCY,

shall be in the following form, and shall be printed on green paper:

Form
1002.
Revised.

CERTIFICATE OF BANK OR COLLECTING AGENCY.

(To be presented with coupons or interest orders when not accompanied by certificate of owners.)

.....
(Give name of debtor.)

.....
(Full description of bonds, giving name of issue and interest rate.)
....., 191.. Amount of coupon or registered interest \$.....
(Date of maturity of interest.)

I (we) do solemnly declare that the bank or collecting agency named below has purchased or accepted for collection the accompanying coupons or interest orders from
(Name of party from whom received.)
of and that no certificate of ownership accompanied said coupons or interest orders, and that I (we) have no knowledge as to who is the owner or owners of the bonds (except as noted on back hereof)* upon which the above-described interest is due, and the bank or collecting agency hereby acknowledges responsibility of withholding therefrom the normal income tax of 1 per cent, in accordance with the regulations of the Treasury Department.

Date,, 191..
(Bank or collecting agency.)

By
(Signature of officer authorized to sign and official position.)

.....
(Full address of bank or withholding agency.)

* NOTE.—If the ownership of bonds is known to person signing this certificate, he must give the name and address of the owner on the back hereof.

(SIGNATURES MUST BE CLEARLY AND LEGIBLY WRITTEN.)

TREASURY DEPARTMENT,
INTERNAL REVENUE — INCOME TAX.

The Journal of Accountancy

Revised Form 1004,

Ownership Certificate — NONRESIDENT ALIENS,

shall be in the following form, and shall be printed on yellow paper:

Form
1004.
Revised.

OWNERSHIP CERTIFICATE — NONRESIDENT ALIENS.

(To be furnished with coupons detached from bonds or other obligations owned by citizens or subjects, firms, corporations, or organizations of foreign countries and who are not residents of the United States.)

.....
(Give name of debtor.)

.....
(Full description of bonds, giving name of issue and interest rate.)

....., 191.. Amount of coupon or registered interest \$.....
(Date of maturity of interest.)

I do solemnly declare that the owner of the bonds from which were detached the accompanying coupons, or upon which there matured the aforesaid registered interest, is a nonresident alien in respect to the United States, and is exempt from the income tax imposed on such income by the United States Government under the law enacted October 3, 1913; that no citizen of the United States wherever residing, or foreigner residing in the United States or in any of its possessions, has any interest in said bonds; and that all of the information as given in this certificate is true and correct.

Date,, 191..

.....
(Signature of owner or, if organization, Name.)

.....
(If organization, signature of official authorized to sign, and official position.)

.....
(Full post-office address of owner.)

NOTE.—When numbers of bonds are required to be given, same are to be entered on back hereof.

(SIGNATURES MUST BE CLEARLY AND LEGIBLY WRITTEN.)

TREASURY DEPARTMENT,
INTERNAL REVENUE — INCOME TAX.

Income Tax Department

Revised Form 1007,

CERTIFICATE CLAIMING EXEMPTION,

allowed citizens and resident aliens under paragraph C, shall be in the following form, and shall be printed on yellow paper:

**Form
1007.
Revised.**

EXEMPTION CERTIFICATE —.

(For claiming exemption at the source as provided in paragraph C of the Federal income tax law of October 3, 1913.)

TREASURY DEPARTMENT,
INTERNAL REVENUE — INCOME TAX.

To
(Give name of withholding agent.)

.....
(Full post-office address.)

I hereby serve you with notice that I am single—married, with my (wife—husband) living with me, and that I now claim the benefit of the exemption of \$....., as allowed in paragraph C of the Federal income tax law of October 3, 1913 (my total exemption under said paragraph being \$.....).

Date,, 191.. Signed:

Address:
(Full post-office address.)

NOTE.—Claim for exemption on Form 1007 can be filed with the debtor or withholding agent at any time, not less than 30 days prior to March first next succeeding the year for which exemption is claimed.

(SIGNATURES MUST BE CLEARLY AND LEGIBLY WRITTEN.)

The Journal of Accountancy

Revised Form 1015,

Ownership Certificate — FIDUCIARY, THE SOURCE,

shall be in the following form, and shall be printed on yellow paper:

Form
1015.
Revised.

OWNERSHIP CERTIFICATE — FIDUCIARY, THE SOURCE.

(To be filed with debtor or withholding agents by fiduciaries claiming exemption from withholding at the source.)

.....
(Give name of debtor.)

.....
(Full description of bonds, giving name of issue and interest rate.)

....., 191.. Amount of coupon or registered interest \$.....
(Date of maturity of interest.)

I (we) do solemnly declare that the estate or trust named below is the owner of the above-described bonds from which were detached the accompanying coupons, or upon which there is due the above-described registered interest, and acting for the estate or trust in the capacity herein stated, I (we) hereby declare that I (we) do now claim exemption from having the normal tax of 1 per cent withheld from said income by the debtor at the source. I (we) hereby assume the duty and responsibility, imposed upon withholding agents under the law, of withholding and paying the income tax due, for which I (we) may be liable.

.....
(Name of fiduciary.) (Capacity in which acting.)

Date,, 191.. For
(Name of estate or trust.)

.....
(Full post-office address.)

NOTE.— When numbers of bonds are required to be given, same are to be entered on the back hereof.

(SIGNATURES MUST BE CLEARLY AND LEGIBLY WRITTEN.)

TREASURY DEPARTMENT,
INTERNAL REVENUE — INCOME TAX.

Income Tax Department

Revised Form 1019,

Certificate of Ownership — FIDUCIARY, NOT SOURCE,

shall be in the following form, and shall be printed on white paper:

Form
1019.
Revised.

OWNERSHIP CERTIFICATE — FIDUCIARY, NOT SOURCE.

(To be filed with debtor or withholding agents by fiduciaries when not claiming any exemption, as an alternative to the filing of Form No. 1015 in which exemption is claimed.)

.....
(Give name of debtor.)

.....
(Full description of bonds, giving name of issue and interest rate.)

....., 191.. Amount of coupon or registered interest \$.
(Date of maturity
of interest.)

I (we) do solemnly declare that the estate or trust named below is the owner of the above-described bonds from which were detached the accompanying coupons, or upon which there is due the above-described registered interest, and acting for the estate or trust in the capacity herein stated, I (we) hereby declare that I (we) do not now claim exemption from having the normal tax of 1 per cent withheld from said income by the debtor at the source.

.....
(Name of fiduciary.) (Capacity in which acting.)

Date,, 191.. For
(Name of estate or trust.)

.....
(Full post-office address.)

NOTE.— When numbers of bonds are required to be given, same are to be entered on the back hereof.

(SIGNATURES MUST BE CLEARLY AND LEGIBLY WRITTEN.)

TREASURY DEPARTMENT,
INTERNAL REVENUE — INCOME TAX.

The Journal of Accountancy

Form 1058,

Substitute Certificate—EXEMPTION CLAIMED,

shall be in the following form, and shall be printed on yellow paper:

Form
1058.

SUBSTITUTE CERTIFICATE—EXEMPTION CLAIMED.

(To be attached to interest coupons when the collecting agent's certificate is substituted for the certificate of owner in which exemption was claimed.)

.....
(Give name of debtor.)

.....
(Full description of bonds, giving name of issue and interest rate.)

....., 191... Amount of coupon or registered interest \$.....
(Date of maturity of interest.)

Total exemption allowed under paragraph C, \$.....
Amount of exemption claimed, \$.....

I (we) do solemnly declare that the owner of the above-described bonds from which were detached the accompanying interest coupons has filed with me (us) a certificate of ownership, Form No., duly executed and filled in according to Treasury Regulations, which certificate has been indorsed by me (us) as required by Treasury Regulations, and that under the provisions of the income tax law and regulations, said interest is exempt from the withholding and payment of the income tax at the sources, or that exemption was claimed as stated herein; and I (we) do hereby promise and pledge myself (ourselves) to forward the said certificate to the Commissioner of Internal Revenue, at Washington, D. C., not later than the 20th day of next month, in accordance with Treasury Regulations.

Date,, 191...
(Name of bank or collecting agency.)

By
(Signature of person authorized to sign, and his official position.)

No.
(Full post-office address of collecting agency.)

TREASURY DEPARTMENT,
INTERNAL REVENUE—INCOME TAX.

Income Tax Department

Form 1059,

Substitute Certificate—EXEMPTION NOT CLAIMED,

shall be in the following form, and shall be printed on white paper:

Form
1059.

SUBSTITUTE CERTIFICATE—EXEMPTION NOT CLAIMED.

(To be attached to interest coupons when collecting agent's certificate is substituted for certificate of owner in which exemption was not claimed.)

(Give name of debtor.)

(Full description of bonds, giving name of issue and interest rate.)

....., 191... Amount of coupon or registered interest \$.....
(Date of maturity of interest.)

I (we)do solemnly declare that the owner of the above-described bonds from which were detached the accompanying coupons has filed with me (us) a certificate of ownership, Form No., duly executed and filled in according to Treasury Regulations, which certificate has been indorsed by me (us) as required by Treasury Regulations, and which certificate did not claim any exemption from having the normal tax of 1 per cent withheld by the debtor at the source; and I (we) do hereby promise and pledge myself (ourselves) to forward the said certificate to the Commissioner of Internal Revenue at Washington, D. C., not later than the 20th day of next month, in accordance with Treasury Regulations.

Date,, 191..

(Name of bank or collecting agency.)

By
(Signature of person authorized to sign, and his official position.)

No.

(Full post-office address of collecting agency.)

All certificates shall be, in size, 8 by 3½ inches, and shall be printed to read from left to right along the 8-inch dimension.

All certificates *claiming exemption* shall be printed on yellow paper; all certificates *not claiming exemption* shall be printed on white paper; and certificate form 1002, for use by the first bank or collecting agency, shall be printed on green paper.

All paper upon which certificates shall be printed shall correspond in weight and texture to white writing paper 21 by 32, about 40 pounds to the ream of 500 sheets.

Certificates heretofore authorized, when properly executed, will be accepted up to October 1, 1914.

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The revised certificates hereby provided will be printed by the Government and furnished without cost for the use of bond owners.

All existing regulations which may be in conflict with the prescriptions of this regulation are hereby superseded.

Individuals or organizations desiring to print their own certificates may do so, but certificates so printed must conform in size and be printed in similar type, upon the same color, shade, and weight of paper as used by the government.^a

^a Sample certificates showing size of type and color of paper can be secured from collectors of internal revenue in their several districts or from the commissioner of internal revenue at Washington, D. C.

(T. D. 1977 May 2, 1914)

Ownership certificate to be executed by foreign banks, bankers, etc., claiming exemption of nonresident alien from income tax on interest on bonds owned by said nonresident alien, *vis.*: Citizens or subjects, firms, corporations, or organizations of foreign countries who are not residents of the United States.

For the purpose of complying with income-tax regulations requiring the filing of certificates of ownership of bonds when presenting coupons or interest orders for collection of interest on bonds of domestic corporations of the United States owned by nonresident aliens as to the United States, a certificate in the form following is provided, which may be executed by responsible banks or bankers in foreign countries for and in behalf of nonresident alien owners of bonds of United States corporations:

Income Tax Department

Form
1060.

**OWNERSHIP CERTIFICATE—NONRESIDENT ALIEN—TO BE
EXECUTED BY BANKS, BANKERS, ETC.**

(For use by foreign banks or bankers, to accompany coupons detached from bonds or other obligations owned by citizens or subjects, firms, corporations, or organizations of foreign countries, and who are not residents of the United States.)

.....
(Give name of debtor.)

.....
(Full description of bonds, giving name of issue and interest rate.)

....., 191... Amount of coupon or registered interest \$.....
(Date of maturity of interest.)

I (we) do solemnly declare that the owners of the bonds from which were detached the accompanying coupons or upon which there matured the aforesaid registered interest are non-resident aliens as to the United States and are exempt from the income tax imposed on such income by the United States Government under the law enacted October 3, 1913; that no citizen of the United States, wherever residing, or foreigner residing in the United States or in any of its possessions, has any interest in said bonds; and that all of the information as given in this certificate is true and correct. I (we) hereby agree that if at any time within three years from the date of this certificate it shall appear that the income or any part thereof represented or covered by this certificate was or is subject to the normal tax imposed by the United States, upon presentation of proof of that fact to me (us) by, from, or through the Commissioner of Internal Revenue, Washington, D. C., I (we) will pay and remit to the United States Government the amount of tax claimed to be due; and I (we) hereby further agree that whenever in the judgment of the Commissioner of Internal Revenue it shall be necessary in or to the administration of the income-tax law, I (we) will, upon request of the said Commissioner of Internal Revenue, disclose and furnish to him the names and addresses of the owners and the amounts of the bonds aforesaid.

Date,, 191...
(Name of bank or banker.)

By
(Signature of official authorized to sign.)

.....
(Official position.)

.....
(Full post-office address of bank or banker.)

NOTE.— When numbers of bonds are required to be given, same are to be entered on back hereof.

(SIGNATURES MUST BE CLEARLY AND LEGIBLY WRITTEN.)

TREASURY DEPARTMENT.
INTERNAL REVENUE — INCOME TAX.

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When foreign banks or bankers shall use the foregoing certificate, they may include in one certificate all the coupons from bonds of the same class and same issue, and may include in one certificate all the interest orders or cheques for interest on registered bonds of the same class and same issue.

The above certificate shall be in size 8 by $3\frac{1}{2}$ inches, and shall be printed to read from left to right along the 8-inch dimension.

The certificate shall be printed on yellow paper and such paper shall correspond in weight and texture to white writing paper 21 by 32, about 40 pounds to the ream of 500 sheets.

The revised certificate hereby authorized will be printed by the Government and furnished without cost.

Individuals or organizations desiring to furnish their own certificates may do so, but certificates so printed must conform in size to that prescribed above and be printed in similar type upon the same color, shade, and weight of paper as used by the government.

Sample certificates showing size of type and color of paper can be secured from collectors of internal revenue in their several districts, or from the commissioner of internal revenue, Washington, D. C.

Students' Department

EDITED BY SEYMOUR WALTON, C. P. A.

The following letter was turned over to this department. It speaks for itself, and is welcomed, as will be any other intelligent criticisms of the department, or of anything which appears in it.

Brooklyn, N. Y., Apr. 25, 1914.

Editor, The Journal of Accountancy:

Dear Sir:

On page 313 of the April number of THE JOURNAL the editor of the *Students' Department* tries to explain double-entry bookkeeping by personifying the business. He conceives of the business as an imaginary person capable of owing and of being owed and regards this imaginary person as the agent of the proprietor, standing between him and the outside world. Therefore, the assets of the proprietor are assets of the business, the liabilities of the proprietor are liabilities of the business, the net asset of the proprietor is a liability of the business to the proprietor, and the assets and liabilities of the business are always equal. In following that line of argument he seems to be unconscious of the fact that he is violating the laws of rational speech, that he is using relative terms from a double standpoint. When he says that the accounts payable are a liability he means liability of the proprietor, and when he says that the net asset is a liability he means liability to the proprietor. He is simply reversing the use of words; liability of the proprietor and liability to the proprietor are opposites.

It seems to me that the time has come when accountants should abandon that untenable position and recognize the fact that their occupation will never stand upon an equal footing with other professions until they learn to use words in their proper sense, until they learn to say *asset* when they mean asset, *liability* when they mean liability, and *net capital* when they mean net capital.

Yours very truly,

C. M. VAN CLEVE

Referring to the above, I think that I have been misquoted. I did not conceive of the business as an imaginary person. In the first hypothesis, I supposed the business to be financed by A, and therefore to belong to him, but to be managed by B, under the name of B & Co., both A and B being real persons. In the second hypothesis, A remains as the proprietor, but B, the manager, is replaced by A as manager. "He is acting as A the capitalist, and A & Co. the business." There is no imaginary person dragged in at all. A is a real person whether he is in one respect the proprietor, or in another respect the manager or representative of the business and its operations. It is not an unusual thing for a man to appear in two capacities. If Jones is the executor of an estate that has current liabilities of \$10,000.00, with no ready money on hand, Jones may advance out of his own funds \$4,000.00 to pay off pressing claims. Jones, as executor now owes \$6,000.00 to ordinary creditors and \$4,000.00 to Jones, the individual. I cannot say that the estate owes these two amounts,

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because Mr. Van Cleve says that would be personifying the estate. Somehow, Jones cannot get it out of his head that some one owes him \$4,000.00, but, of course he is mistaken, because if anyone does, the amount is an asset to Jones, which according to Mr. Van Cleve it cannot be, because it is a liability of Jones, executor. Substituting executor for proprietor, he says; "He is simply reversing the use of words; liability of the proprietor (executor) and liability to the proprietor (executor) are opposites."

As a matter of fact, it is impossible for a money debt to exist that is not dual in character. If Smith buys \$1,000.00 worth of goods from Brown, the \$1,000.00 is both a liability and an asset, an account payable on Smith's books and an account receivable on Brown's. If Smith gives his note for the amount it is his note payable and Brown's note receivable. A bond of the city of New York is an asset in the hands of an investor and a liability on the part of the city.

I am perfectly in accord with Mr. Van Cleve in his statement that accountants should use words in their proper sense. Let us begin with his use of the words "net asset." I cannot find any place where I have said that net assets are a liability. Net assets are what is left when all debts other than those of the proprietor are paid or provided for. They are still assets and nothing can change their character as long as they exist. Offsetting them is net worth, which is a liability to be paid for out of their proceeds. Because net assets are, of necessity, the same amount as net worth is no excuse for confusing the two terms, and calling net assets a liability. But net worth is only another name for net capital. If net capital is not a liability by some person or some things to the owner of the capital, what is it? Merely because it is not exigible until the business is wound up does not change its inherent character. When the business is wound up, the capitalist receives his money, or what there is left of it, his net capital. No person ever receives money, as a business proposition, from another, unless that other is liable to him for it. If the net capital is a liability to the capitalist in the final settlement, why has it not been a liability to him during the whole life of the business? Merely stating that it was not is no argument.

I do not think that I am "violating the laws of rational speech," when I claim that accounts payable are a liability of the proprietor, because incurred for his benefit, while net worth or net capital (not net assets) is a liability to the proprietor, because it was contributed by him and must eventually be repaid to him.

If the business of A & Co. is only one part of A's personal fortune, and he keeps a complete set of personal books, how would his investment in A & Co. appear on those books? Unquestionably as an asset, a money debt due eventually from A & Co. But since every money debt is both an asset and a liability, this asset on A's personal books must have its corresponding liability somewhere. If it is not on A & Co.'s books in A's capital account, where is it?

Students' Department

C. P. A. EXAMINATIONS

The object of the following remarks is not to make invidious criticisms of any particular examination, or to find fault with any one board of examiners. The idea is entirely to stimulate a discussion in this department that will result in a general consensus of opinion as to the character of the questions to be asked, and also as to the kind of answers that are to be expected. In regard to the answers, it is very important to the applicant that he know to what extent he is to elaborate his statements and how much he is expected to explain his conclusions. Therefore, criticism is freely invited of the answers as submitted. If they are not properly set up, or if anything essential is omitted, let the examiners say so.

The fact that the problems submitted are taken from the Virginia examination of last October is a mere accident. They happened to be available at the time, and were not specially selected.

The first one is an example of many in which too little information is given to enable one to answer it as it should be answered. A general statement could have been made as to the proportionate value of the space occupied by each department and as to the cost of the furniture and fixtures in each, which would afford a basis for the allocation of expenses other than those directly chargeable to each department, without intimating just how the allocation is to be made.

An accurate trading account for each department is impossible from the data submitted. In such a business all the expenses that are incurred for each department specifically should be charged to that department. Rent and other house expense, such as janitor service, should be allocated on the rental value of the space occupied by each department, based on its location as well as on the number of square feet occupied. The haberdashery would probably be located near the entrance, with the idea that men visiting either of the other departments might be attracted by some necktie or other article that might strike their fancy as they passed. This department should therefore be charged more per square foot than the others.

Insurance should be charged to each department on the basis of the average stock carried in each.

Depreciation on furniture and fixtures for each department should be based on the value of the equipment in each. As clothing is usually kept in piles on comparatively cheap tables, and shoes are carried in boxes fitting into pigeonholes against the wall, while haberdashery would be kept in glass showcases, the value of the equipment of the smaller department might easily be greater than that of the other two together. To none of these things is there any clue in the problem.

All this is very confusing to the examinee, who has only a few minutes in which to make up his mind as to the proper treatment to give each item. He probably knows enough to be sure that the examiners want some disposition made of the rent, insurance, depreciation, and possibly general expense and office salaries, other than carrying them as unallocated expenses of the whole business. Otherwise his departmental trading ac-

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count is a matter of simple arithmetic—inventory plus purchases minus inventory equals cost of goods sold. Adding wages and deducting the total from sales gives gross profit of the department.

In this dilemma, he jumps to the conclusion that the examiner wants him to allocate the expenses on the basis of the sales. Possibly he is right as to the wishes of the examiner, but he is certainly wrong in the accounting principle. The value of the goods sold is no criterion of the rental to be charged. If it were, a small tray of diamonds in a jewelry store would be charged more rent than cheap plated silverware occupying a dozen shelves.

Possibly, the intention is to spread the expense on the ratio of the direct wages, which vary rather closely in harmony with the sales; but again there is no necessary connection.

It would have been comparatively easy to have given the data necessary to an intelligent understanding of these points, such as an accountant on the spot could quickly ascertain for himself. Then the accounting ability of the applicant would be shown by the way in which he treated the data. As it stands, the problem is a question of mere bookkeeping. After the gross profits of the three departments are ascertained, as indicated, there would be deducted the general expense, office salaries, rent, taxes, insurance, and depreciation to find the profit from operations. Then the bad debts would be deducted to find the net profit of the business. The disposition of profits would show first the interest on partners' capital and finally the division of the remainder between the two partners. The crediting of interest on capital is, of course, entirely useless, since profits are divided on the capital ratios, but the problem calls for it.

The problem as it stands is as follows:

PROBLEM

The ledger of the firm of Cutter & Fitler, retail dealers in men's clothing and furnishings, showed the following balances on December 31, 1912:

| | Dr. | Cr. |
|-------------------------------|-------------|--------------|
| Cash | \$ 2,896.14 | |
| Accounts receivable | 28,226.06 | |
| Bills receivable | 1,650.00 | |
| Furniture and fixtures | 6,344.92 | |
| Accounts payable | | \$ 12,518.30 |
| Bills payable | | 5,598.66 |
| Inventory, Jan. 1, 1912: | | |
| Clothing department | 12,689.54 | |
| Shoe department | 5,219.78 | |
| Haberdashery department | 4,711.44 | |
| Purchases: | | |
| Clothing department | 36,148.83 | |
| Shoe department | 15,201.34 | |
| Haberdashery department | 12,680.27 | |

Students' Department

| | | |
|---------------------------------------|---------------------|---------------------|
| Sales: | | |
| Clothing department | | 54,723.57 |
| Shoe department | | 23,107.82 |
| Haberdashery department | | 18,560.26 |
| Wages: | | |
| Clothing department | 2,867.50 | |
| Shoe department | 1,324.80 | |
| Haberdashery department | 987.65 | |
| General expenses | 1,834.19 | |
| Office salaries | 1,450.00 | |
| Rent | 3,000.00 | |
| Taxes | 782.96 | |
| Insurance | 387.39 | |
| Bad debts | 463.28 | |
| Amos Cutter, capital account | | 20,000.00 |
| Hiram Fitler, " | | 10,000.00 |
| Amos Cutter, withdrawal account | 3,701.68 | |
| Hiram Fitler, " | 1,850.84 | |
| | <u>\$144,508.61</u> | <u>\$144,508.61</u> |

Inventories on December 31, 1912, are as follows:

| | |
|--------------------------------------|--------------|
| Clothing department | \$ 14,466.23 |
| Shoe department | 4,913.62 |
| Haberdashery department | 5,028.96 |
| Prepayments on that date are: | |
| Taxes | 168.22 |
| Insurance | 57.30 |

There are no accrued liabilities.

Depreciation of 10% is to be written off from furniture and fixtures.

Each partner is to be credited with 6% interest on his capital.

No interest is to be charged on partners' withdrawals.

Net profit or loss to be divided: Cutter 2/3, Fitler 1/3.

Prepare the following:

- 1—Trading account for each department.
- 2—Profit and loss account.
- 3—Capital account of each partner.
- 4—Balance sheet.

SOLUTION

Trading Accounts

Clothing Department

| | | | |
|-------------------------|---------------------|--------------------------|---------------------|
| Inventory, Jan. 1 | \$ 12,680.54 | Sales | \$ 54,723.57 |
| Purchases | 36,148.83 | Inventory, Dec. 31 | 14,466.23 |
| Wages | 2,867.50 | | |
| Trading gross profit .. | 17,483.93 | | |
| | <u>\$ 69,189.80</u> | | <u>\$ 69,189.80</u> |

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Shoe Department

| | | | |
|-------------------------|---------------------|--------------------------|---------------------|
| Inventory, Jan. 1 | \$ 5,219.78 | Sales | \$ 23,107.82 |
| Purchases | 15,291.34 | Inventory, Dec. 31 | 4,913.62 |
| Wages | 1,324.80 | | |
| Trading gross profit .. | 6,185.52 | | |
| | <u>\$ 28,021.44</u> | | <u>\$ 28,021.44</u> |

Haberdashery Department

| | | | |
|--------------------------|---------------------|--------------------------|---------------------|
| Inventory, Jan. 1 | \$ 4,711.44 | Sales | \$ 18,560.26 |
| Purchases | 12,680.27 | Inventory, Dec. 31 | 5,028.96 |
| Wages | 987.65 | | |
| Trading gross profit ... | 5,209.86 | | |
| | <u>\$ 23,589.22</u> | | <u>\$ 23,589.22</u> |

Profit and Loss

| | | | |
|---|---------------------|--------------------------|---------------------|
| General expense | \$ 1,834.19 | Clothing profit | \$ 17,483.93 |
| Office salaries | 1,450.00 | Shoe profit | 6,185.52 |
| Rent | 3,000.00 | Haberdashery profit | 5,209.86 |
| Taxes | 614.74 | | |
| Insurance | 330.09 | | |
| Bad debts | 463.28 | | |
| Dep'n furniture and fix- tures | 634.49 | | |
| Net profit | 20,552.52 | | |
| | <u>\$ 28,879.31</u> | | <u>\$ 28,879.31</u> |

Disposition of Profit

| | | | |
|-------------------------------|---------------------|------------------|---------------------|
| Interest, Cutter's capital \$ | 1,200.00 | Net profit | \$ 20,552.52 |
| " Fittler's " | 600.00 | | |
| Cutter 2-3 of remainder | 12,501.68 | | |
| Fittler 1-3 " | 6,250.84 | | |
| | <u>\$ 20,552.52</u> | | <u>\$ 20,552.52</u> |

The partners' accounts are shown in the balance sheet.

Students' Department

BALANCE SHEET, DECEMBER 31ST, 1913

| <i>Assets</i> | | <i>Liabilities</i> | |
|---------------------------|---------------------|------------------------|---------------------|
| Furniture and fixtures . | \$ 5,710.43 | Amos Cutter, capital: | |
| Inventories: | | Balance | |
| Clothing .. | \$14,466.23 | Jan. 1 .. | \$20,000.00 |
| Shoes | 4,913.62 | Interest ... | 1,200.00 |
| Haberdash- | | Profit | 12,501.68 |
| ery | 5,028.96 | | <u>\$33,701.68</u> |
| | 24,408.81 | Drawings . | 3,701.68 |
| Bills receivable | 1,650.00 | | \$ 30,000.00 |
| Accounts receivable | 28,226.06 | Hiram Fitler, capital: | |
| Cash | 2,896.14 | Balance | |
| Deferred charges: | | Jan 1 .. | \$10,000.00 |
| Taxes | 168.22 | Interest ... | 500.00 |
| Insurance . | 57.30 | Profits ... | 6,250.00 |
| | 225.52 | | <u>\$16,850.84</u> |
| | | Drawings . | 1,850.84 |
| | | | 15,000.00 |
| | | Accounts payable | 12,518.30 |
| | | Bills payable | 5,598.66 |
| | | | <u>\$ 63,116.96</u> |
| | <u>\$ 63,116.96</u> | | <u>\$ 63,116.96</u> |

PROFIT AND LOSS

As an example of the incorrect use of a term and the equally incorrect treatment of a subject may be cited profit and loss. This term should be applied solely to the account through which the nominal accounts arising from the normal operations of a business are periodically cleared. The items entering into it are only those which arise during the period covered by it. The final balance of the account will, therefore, represent the net profit or loss of the normal operations of the period. Any other increases or decreases of the net worth of the business should be reflected in the surplus account. The surplus is the sum of the total undistributed profits to date, and has been accumulated for the purpose of providing for any contingencies that may arise outside of the regular business operations.

Such a contingency is a loss by fire. To put such a loss into the profit and loss account of the year is virtually saying that a fire is part of the normal operations of the business.

The following problem from the Virginia examination has recently been answered in print by bringing in the loss by fire as part of the closing profit and loss entries, which end with a balance, net loss \$84.94, for the period.

Accountants should be very particular as to the treatment given such a subject, especially when they publish their answers. The student who reads such an answer in a magazine that is supposed to make a specialty of accounting subjects is led to adopt wrong views, and is more to be

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pitied than blamed when a similar answer may gain him a low mark in an examination.

As to the problem, it is eminently fair and well stated. All the information necessary is clearly given, and there is no special technical principle that every accountant is not expected to know. The application of the 80% clause cannot be called a technicality, because it is something that every business man is expected to know.

PROBLEM

The Carson Clothing Company, wholesale dealers in men's clothing, were burned out on the night of September 30th, their furniture, fixtures and merchandise being a total loss.

On June 30, 1913, (the date of their last inventory) the company's condition was as follows:

| <i>Assets</i> | | <i>Liabilities</i> | |
|--------------------------|---------------------|------------------------|---------------------|
| Cash | \$ 6,473.62 | Accounts payable | \$ 33,482.53 |
| Accounts receivable | 59,618.24 | Bills payable | 16,201.11 |
| Bills receivable | 9,203.16 | | |
| Mdse. inventory | 29,592.67 | | \$ 49,773.64 |
| Furniture and fixtures.. | 2,293.17 | <i>Capital Etc.:</i> | |
| Prepaid taxes and ins... | 476.24 | Capital stock | 40,000.00 |
| | | Surplus | 17,883.46 |
| | | | |
| | <u>\$107,657.10</u> | | <u>\$107,657.10</u> |

After entering and posting all transactions to the close of business on September 30th, their ledger shows the following balances:

| | | |
|--------------------------------|---------------------|---------------------|
| Cash | \$ 3,417.97 | |
| Accounts receivable | 71,029.82 | |
| Bills receivable | 8,314.11 | |
| Inventory, June 30, 1913 | 29,592.67 | |
| Furniture and fixtures | 2,293.17 | |
| Dividends | 6,000.00 | |
| Accounts payable | | \$ 38,947.10 |
| Bills payable | | 19,254.38 |
| Capital stock | | 40,000.00 |
| Surplus | | 17,883.46 |
| Sales | | 63,857.68 |
| Merchandise purchases | 48,300.59 | |
| Salaries and wages | 2,892.50 | |
| Expenses | 2,482.13 | |
| Advertising | 1,624.50 | |
| Insurance | 319.11 | |
| Taxes | 483.17 | |
| Selling expenses | 3,192.88 | |
| | | |
| | <u>\$179,942.62</u> | <u>\$179,942.62</u> |

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The company's gross profit on sales has been very uniform, averaging twenty-five (25) per cent ever since the business was started. Ten (10) per cent for depreciation has been written off from furniture and fixtures every year.

The insurance carried was \$25,000 on merchandise and \$2,000 on furniture and fixtures, all policies containing the 80% co-insurance clause.

Prepare the following:

- 1 — Statement showing amount of loss and amount of claim against the insurance companies.
- 2 — Profit and loss account as of Oct. 1, 1913, (the prepaid taxes on that date being \$238.10).
- 3 — Balance sheet as of Oct. 1, 1913.

SOLUTION

As the gross profit on sales has been uniform at twenty-five per cent, deducting that percentage from the sales will give the cost of the goods sold in the period. Knowing this, the approximate value of the inventory at the time of the fire is found thus:

| | |
|--|----------------------------|
| Inventory, June 30, 1913 | \$ 29,592.67 |
| Purchases since | 48,300.59 |
| | <u>\$ 77,893.26</u> |
| Cost of goods sold, 75% of \$63,857.68 | 47,893.26 |
| Approximate inventory | <u><u>\$ 30,000.00</u></u> |

As 80% of \$30,000.00 is \$24,000.00 and they were carrying \$25,000.00, the 80% co-insurance clause is covered, as is also true of the furniture and fixtures.

FIRE LOSS

| | | | |
|---------------------------|---------------------|----------------------------|----------------------------|
| Inventory | \$ 30,000.00 | Claim against ins. co. ... | \$ 27,000.00 |
| Furniture and fixtures .. | 2,235.84 | Loss, dr. to surplus | 5,554.95 |
| Unexpired insurance ... | 319.11 | | |
| | <u>\$ 32,554.95</u> | | <u><u>\$ 32,554.95</u></u> |

This is not strictly accurate, since three months' insurance should have been taken up in the profit and loss, but we have no means of judging how much this would be. As the policies are cancelled by a total loss, the unexpired insurance is wiped out, and since this was done by the fire, it is a proper charge to fire loss. This is a point seldom noticed in making the statement of a loss by fire.

An account should always be opened for fire loss, to which will be charged the assets lost at their book value. If any of them are fixed assets, such as machinery, they should first be reduced to their book value

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by a credit to them of the reserve for depreciation. A record is thus made on the books in permanent form. As soon as the loss is adjusted, the fire loss account may be credited and the insurance companies charged, or the credit may be deferred until the money is paid, and may then be made direct from the cash book. In any event, the balance of fire loss account is covered into surplus, and not into profit and loss. It is an extraordinary and not a normal loss of the business.

PROFIT AND LOSS, THREE MONTHS ENDED SEPTEMBER 30, 1913

| | | | |
|--|---------------------|-----------------------------|---------------------|
| Inventory, June 30, '13 ..\$ | 29,592.67 | Sales | \$ 63,857.68 |
| Purchases | 48,300.59 | Inventory, Sept. 30, '13 .. | 30,000.00 |
| Salaries and wages | 2,892.50 | | |
| Expenses | 2,482.13 | | |
| Advertising | 1,624.50 | | |
| Taxes | 245.07 | | |
| Selling expense | 3,192.88 | | |
| Furniture and fixtures, dep'n | 57.33 | | |
| Trading profit | 5,470.01 | | |
| | <u>\$ 93,857.68</u> | | <u>\$ 93,857.68</u> |

SURPLUS

| | | | |
|----------------------------|---------------------|---------------------------|---------------------|
| Fire loss | \$ 5,554.95 | Balance June 30, '13 ..\$ | 17,883.46 |
| Dividend paid | 6,000.00 | Profits as above | 5,470.01 |
| Balance, Sept. 30, '13 ... | 11,798.52 | | |
| | <u>\$ 23,353.47</u> | | <u>\$ 23,353.47</u> |

BALANCE SHEET, SEPTEMBER 30TH, 1913

| <i>Assets</i> | | <i>Liabilities</i> | |
|--------------------------|---------------------|------------------------|---------------------|
| Cash | \$ 3,417.97 | Accounts payable | \$ 38,947.10 |
| Accounts receivable | 71,029.82 | Notes payable | 19,254.38 |
| Notes receivable | 8,314.11 | Capital stock | 40,000.00 |
| Insurance companies .. | 27,000.00 | Surplus | 11,798.52 |
| Prepaid taxes | 238.10 | | |
| | <u>\$110,000.00</u> | | <u>\$110,000.00</u> |

This brings out clearly the true situation, both as to the trading profit and the financial condition.

BANK STATEMENTS

The second problem of the Virginia examination requires an intimate knowledge of the national bank law. The same is true of the fifth question

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in auditing in the same examination which asks for a statement of the legal reserve of a bank whose figures are given in detail.

It is questionable to what extent examiners are justified in giving problems and questions that require a knowledge of technical points peculiar to a certain line of business, as distinguished from general accounting principles that govern all commercial transactions. It is not necessary for an accountant to have at his finger ends the peculiar technical requirements, because he can easily acquaint himself with them when occasion requires. A national bank examiner would naturally know them all, because he is in constant touch with them, but an ordinary accountant, doing a varied class of work, would only occasionally need this technical knowledge, and cannot be expected to burden his mind trying to remember it. Every national bank has a copy of the law and of the rules and regulations of the department, reference to which will give the accountant all the information he needs. A lawyer is not expected to give an opinion off-hand on any intricate legal point, but he is supposed to know what the general principles of law are. It does not seem unreasonable to apply the same rule to accountants.

In the following bank problem, it may be admitted that any one should know that the funds on deposit with the reserve agents of the East End National Bank, would not serve as part of the reserve of the Central National Bank, an entirely different institution, but even that requires a knowledge of how one bank makes arrangements to have another act as its reserve agent. It is doubtful whether all, even among national bank men, would know just what would be the status of the circulation, the bonds securing it, and the redemption fund with the treasurer of the United States.

PROBLEM

An agreement has been reached whereby the Central National Bank is to absorb the East End National Bank. The former is to assume all of the liabilities of the latter and is to take over all of the latter's assets, excepting the banking house and fixtures (which are to be conveyed to a trustee, for sale and distribution of the proceeds among the East End stockholders) and such loans and discounts as prove, upon investigation, to be worthless. After these matters have been adjusted, if the book value of the East End stock be greater than that of the Central, the holders of the former are to receive the difference in cash; or, if it be less, they are to pay the difference. The conditions of the two banks, as disclosed by their statements, are as follows:

| | Central Nat. Bank | East End Nat. Bank |
|---|----------------------|-----------------------|
| <i>Resources:</i> | | |
| Loans and discounts | \$11,736,612.78 | \$1,518,727.99 |
| U. S. bonds to secure circulation | 2,000,000.00 | 250,000.00 |
| Bonds and other securities owned | 857,852.93 | 370,244.25 |
| Banking house and fixtures | 60,000.00 | 40,500.00 |

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| | | |
|--|------------------------|-----------------------|
| Due from banks and bankers | 1,962,056.25 | 281,933.18 |
| " approved reserve agents | 1,996,618.96 | 199,179.10 |
| Cheques and other cash items | 95,652.28 | 24,247.54 |
| Exchanges for clearing house | 641,115.67 | 83,411.83 |
| Notes of other national banks | 91,540.00 | 2,850.00 |
| Fractional currency, etc. | 5,011.93 | 1,974.76 |
| Lawful money reserve in bank | 1,413,023.00 | 411,218.00 |
| Redemption fund with U. S. treasurer | 100,000.00 | 12,500.00 |
| | <u>\$20,959,483.80</u> | <u>\$3,196,786.65</u> |

Liabilities:

| | | |
|--------------------------------|------------------------|-----------------------|
| Capital stock paid in | \$ 2,000,000.00 | \$ 200,000.00 |
| Surplus | 1,500,000.00 | 175,000.00 |
| Undivided profits | 494,400.00 | 77,148.23 |
| Unearned discount | 129,671.56 | 10,495.55 |
| Circulation | 1,796,700.00 | 247,400.00 |
| Due to banks and bankers | 4,408,270.38 | 472,646.47 |
| Cashier's cheques | 142,978.16 | 15,585.56 |
| Certified cheques | 359,105.40 | 46,226.71 |
| Certificates of deposit | 1,147,639.95 | 402,472.45 |
| Individual deposits | 8,980,718.35 | 1,549,811.68 |
| | <u>\$20,595,483.80</u> | <u>\$3,196,786.65</u> |

Show the book value of Central stock.

Show the book value of East End stock, after eliminating the banking house and fixtures and after charging off the worthless paper, which amounts to \$11,648.23.

Show the amount per share to be received or paid by the East End stockholders to equalize the book values.

Show the condition of the Central after the consolidation has been effected.

SOLUTION

The book value of the Central National Bank is found by dividing the sum of the capital stock, surplus and undivided profits, that is, \$3,994,400.00, by 20,000, the number of shares. It is \$199.72 per share.

After charging off the banking house and the bad debts against undivided profits, the East End National Bank will have a total book value of \$400,000.00, and therefore a book value of \$200.00 per share.

Before the consolidation is made, the East End bank will pay its stockholders 28 cents per share, or \$5,600.00 in all, which we will assume is paid out of the national bank notes.

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CENTRAL NATIONAL BANK (After consolidation)

| <i>Resources</i> | | <i>Liabilities</i> | |
|--------------------------------------|------------------------|-----------------------------|------------------------|
| Loans and discounts | \$13,243,692.54 | Capital stock paid in | .\$ 2,200,000.00 |
| U. S. bonds to secure cir'n. | 2,250,000.00 | Surplus | 1,675,000.00 |
| Bonds and other se- curities | 1,228,097.18 | Undivided profits | 518,840.00 |
| Banking house and fixtures | 60,000.00 | Unearned discount | 140,167.11 |
| Due from banks and bankers | 2,243,989.43 | Circulation | 2,044,100.00 |
| Due from approved res. agents | 2,195,798.06 | Due to banks and bankers | 4,880,916.85 |
| Cheques and cash items | 119,899.82 | Cashier's cheques | 158,563.72 |
| Exchanges for clear- ing house | 724,527.50 | Certified cheques | 405,332.11 |
| Notes of other na- tional banks | 93,830.00 | Certificates of deposit | 1,550,112.40 |
| Fractional currency, etc. | 6,986.69 | Individual deposits | 10,530,530.03 |
| Lawful money re- serve in bank | 1,824,241.00 | | |
| Redemption fund with U. S. treas. | 112,500.00 | | |
| | <u>\$24,103,562.22</u> | | <u>\$24,103,562.22</u> |

Notes. The amounts due from approved reserve agents of the East End National Bank would appear on the Central National's books as due from banks and bankers, unless drafts were drawn on the East End's correspondents in favor of the reserve agents of the Central. As this is such a simple expedient, we have assumed that it would surely be done. Or the Central might have made application to the comptroller in advance to have the East End's agents designated as theirs, if they wished to keep valuable connections. It is not likely that they would allow nearly \$200,000.00 to be changed from reserves to mere banks and bankers.

The above statement would then be one that they would be justified in publishing. On the Central's books, however, the circulation and redemption fund of the East End would have to be shown separately, until they could send to Washington \$234,900.00 for the credit of the East End's redemption fund, which would release the \$250,000.00 of that bank's U. S. bonds to secure circulation. After the transfer of these bonds to the Central, the latter bank could order new currency of its own against them, if it saw fit. In the meantime, it would cancel off the East End's redemption fund against that bank's circulation.

Of course, the book value of the consolidated stock would be \$4,393,840.00, the total of the capital, surplus and undivided profits, divided by 22,000, the total number of shares, or \$199.72, the same as it was before consolidation.

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The fourth problem is an excellent test of the student's ability to treat with the question as to what constitutes the cost of a property that is being developed, preparatory to being offered for sale, and to the setting up of the trading statements. Opinions may differ as to the treatment of the rents received, but all points in regard to this or any other doubtful items will be covered if the student explains his method of dealing with it and gives a plausible reason for it.

PROBLEM

Trial Balance, September 30, 1913

| | Dr. | Cr. |
|---|-----------------------|-----------------------|
| Cash | 7,094.38 | |
| 1st mortgage land notes | 222,846.00 | |
| 2d " " | 14,633.00 | |
| Accounts payable | | \$ 4,260.85 |
| Bills payable | | 35,000.00 |
| Bonds payable | | 400,000.00 |
| Commissions payable | | 5,743.19 |
| Real estate—Hilltop Heights | 153,000.00 | |
| " Paradise Park | 261,000.00 | |
| " Tango Terrace | 160,000.00 | |
| Capital stock | | 300,000.00 |
| Trunk sewer (see note) | 11,500.00 | |
| Development—Hilltop Heights | 21,250.00 | |
| " Paradise Park | 50,750.00 | |
| " Tango Terrace | 40,000.00 | |
| Taxes—Hilltop Heights | 1,881.79 | |
| " Paradise Park | 3,763.57 | |
| " Tango Terrace | 5,540.87 | |
| Agents' commissions—Hilltop Heights | 7,903.78 | |
| " " Paradise Park | 15,807.55 | |
| " " Tango Terrace | 7,431.51 | |
| Expenses—Hilltop Heights | 498.03 | |
| " Paradise Park | 222.70 | |
| " Tango Terrace | 659.75 | |
| Advertising—Hilltop Heights | 2,666.09 | |
| " Paradise Park | 3,718.40 | |
| " Tango Terrace | 3,816.26 | |
| Sales—Hilltop Heights | | 78,000.00 |
| " Paradise Park | | 132,000.00 |
| " Tango Terrace | | 86,100.00 |
| Rents received—Hilltop Heights | | 211.09 |
| " " Tango Terrace | | 1,629.16 |
| Interest | 26,815.37 | |
| Officers' salaries | 10,300.00 | |
| Wages—stenographers and clerks | 6,827.50 | |
| Office expenses | 1,388.58 | |
| General expenses | 1,629.16 | |
| | <u>\$1,042,944.29</u> | <u>\$1,042,944.29</u> |

Students' Department

The foregoing is the September 30th (1913) trial balance of the Altruria Land Company, a corporation engaged in the purchase, development and sale of various suburban properties, now operating three tracts, the areas of which are as follows:

| | Bought | Sold | Remainder |
|-----------------------|-----------------|-----------------|-----------------|
| Hilltop Heights | 850,000 sq. ft. | 120,000 sq. ft. | 730,000 sq. ft. |
| Paradise Park | 1,450,000 " " | 240,000 " " | 1,210,000 " " |
| Tango Terrace | 2,000,000 " " | 210,000 " " | 1,790,000 " " |

The trunk sewer, which cost \$11,500.00, drains Hilltop Heights and Paradise Park, which properties adjoin each other, but it has no connection with Tango Terrace, which is in a different locality. The cost of this sewer has not been divided between the properties it drains, but the management decides that its cost should be pro-rated on a basis of the areas of the tracts affected.

On September 30, 1913, interest prepayments amount to \$661.41 and prepaid taxes are as follows:

| | |
|-----------------------|-------------------|
| Hilltop Heights | \$ 213.42 |
| Paradise Park | 434.87 |
| Tango Terrace | 620.96 |
| | <u>\$1,269.25</u> |

You are required to show:

- 1—Trading account for each property.
- 2—Profit and loss account.
- 3—Balance sheet.

SOLUTION

The first step is to ascertain the cost of each separate property per square foot up to the time when it is developed and ready for sale. This would include the original cost of the real estate, the development expense, and in the case of two of them, the cost of the trunk sewer. The cost of the sewer applies only to Hilltop Heights and Paradise Park. The proportionate area of these two properties is $17/46$ and $29/46$ respectively, therefore \$4,250.00 of the cost of the sewer is chargeable to Hilltop Heights, and \$7,250.00 to Paradise Park.

The cost of the three properties is:

| | Hilltop Heights | Paradise Park | Tango Terrace |
|----------------------------|---------------------|---------------------|---------------------|
| Real estate | \$153,000.00 | \$261,000.00 | \$160,000.00 |
| Development | 21,250.00 | 50,750.00 | 40,000.00 |
| Trunk sewer | 4,250.00 | 7,250.00 | |
| | <u>\$178,500.00</u> | <u>\$319,000.00</u> | <u>\$200,000.00</u> |
| The square feet are | 850,000 | 1,450,000 | 2,000,000 |
| Cost per square foot | 21c | 22c | 10c |

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TRADING ACCOUNTS

HILLTOP HEIGHTS:

| | | |
|--|--------------|-------------|
| Sales | \$ 78,000.00 | |
| Less agents' commissions | 7,903.78 | |
| Net sales | \$ 70,096.22 | |
| Cost of land sold, 120,000 sq. ft. @ 21c | 25,200.00 | |
| Gross profit | | \$44,896.22 |
| Taxes | 1,668.37 | |
| Expense | 498.03 | |
| Advertising | 2,666.09 | |
| | \$ 4,832.49 | |
| Less rents received | 211.09 | 4,621.40 |
| Trading profit | | \$40,274.82 |

PARADISE PARK:

| | | |
|--|--------------|-------------|
| Sales | \$132,000.00 | |
| Less agents' commissions | 15,807.55 | |
| Net sales | \$116,192.45 | |
| Cost of land sold, 240,000 sq. ft. @ 22c | 52,800.00 | \$63,392.45 |
| Taxes | \$ 3,328.70 | |
| Expenses | 222.70 | |
| Advertising | 3,718.40 | 7,269.80 |
| Trading profit | | \$56,122.65 |

TANGO TERRACE:

| | | |
|---|--------------|-------------|
| Sales | \$ 86,100.00 | |
| Less agents' commissions | 7,431.51 | |
| Net sales | \$ 78,668.49 | |
| Cost of land sold 210,000 sq. ft. @ 10c | 21,000.00 | |
| Gross profit | | \$57,668.49 |
| Taxes | \$ 4,919.91 | |
| Expenses | 659.75 | |
| Advertising | 3,816.26 | |
| | \$ 9,395.92 | |
| Less rents received | 1,629.16 | 7,766.76 |
| Trading profit | | \$49,901.73 |

Students' Department

PROFIT AND LOSS

| | | | |
|------------------------|---------------------|----------------------|---------------------|
| Interest | \$ 26,153.96 | Trading profit: | |
| Office salaries | 10,300.00 | Hilltop Heights | \$ 40,274.82 |
| Wages, stenographer | | Paradise Park | 56,122.65 |
| and clerks | 6,827.50 | Tango Terrace | 49,901.73 |
| Office expenses | 1,388.58 | | |
| General expenses | 1,629.16 | | |
| Net profit | 100,000.00 | | |
| | <u>\$146,299.20</u> | | <u>\$146,299.20</u> |

ALTRURIA LAND COMPANY

BALANCE SHEET — SEPTEMBER 30, 1913

| <i>Assets</i> | | <i>Liabilities</i> | |
|-------------------------|---------------------|------------------------|---------------------|
| Real estate: | | Capital stock | \$300,000.00 |
| Hilltop Heights, | | Surplus | 100,000.00 |
| 730,000 ft. @ 21c. . | \$153,300.00 | Bonds payable | 400,000.00 |
| Paradise Park, | | Notes payable | 35,000.00 |
| 1,210,000 ft. @ 22c | 266,200.00 | Accounts payable | 4,260.85 |
| Tango Terrace, | | Commissions payable .. | 5,743.19 |
| 1,790,000 ft. @ 10c | 179,000.00 | | |
| 1st mortgage land notes | 222,846.00 | | |
| 2nd " " " | 14,633.00 | | |
| Taxes paid in advance | 1,269.25 | | |
| Interest paid in ad- | | | |
| vance | 661.41 | | |
| Cash | 7,094.38 | | |
| | <u>\$845,004.04</u> | | <u>\$845,004.04</u> |

In the trading statements, the rents received are deducted from the expenses, instead of being added to the gross profits, because the business of the company was that of developing and selling real estate, and not of renting it. Therefore the rent was rather an offset to the expense than a regular source of income.

There is one point not covered in this problem, nor in the solution. The status of the bonds payable is not given. If they were secured by a blanket mortgage on all the real estate, the company cannot give a clear title to any of the lots, when the purchasers have paid for them, unless there is a provision in the trust deed providing for the release of specific lots upon the payment to the trustee of a definite sum per lot. Mortgages on property that is being subdivided and sold in parcels usually contain such a provision.

Book Department

ELECTRIC LIGHT ACCOUNTS AND THEIR SIGNIFICANCE.

By H. M. EDWARDS, Auditor, The New York Edison Company;
McGraw-Hill Book Co. Inc., New York, 1914. Price \$2.00 net.

Mr. Edwards has furnished the first adequate treatment of this subject. Following with very little variation the uniform system of accounts of the National Electric Light Association and the system prescribed by the public service commissions of New York, the author has amplified the rules of the codes referred to with an illuminating explanation of the significance of the accounts. The book is divided into three parts treating respectively of balance sheet or indicant accounts, income accounts and miscellaneous. The accounting structure is carefully covered in the first two parts, each account being concisely but fully explained. In the third part the author discusses at greater length some of the more important phases of the accounting and devotes a chapter to the work order system with special reference to its applicability in accounting for the cost of the unit plant investment and as a control on expenditures under budgetary authorizations.

The troublesome problem of depreciation and depreciation reserves is treated more as a managerial policy than an accounting and engineering problem. What the author calls the "specific" method for providing a reserve (*i.e.*, annual appropriations of fractions of original cost less scrap recovery value) he concedes to be theoretically correct but he inclines to a more "general" method because of the frequent retirement of plant units on account of obsolescence and inadequacy—a condition brought about by the rapid development of improvements in central station practice and the frequent abnormal increases in business which necessitate the supersession of original installations with units of greater capacity. While the accumulation of a reserve by means of a rate applied to the quantity of current generated or sold may prove adequate, it is not *per se* an accounting for depreciation, as there is no necessary relation between cost less scrap value and either current generated or sold. The fact that capacity and, consequently, sales increase more rapidly than capital outlay furnishes the strongest argument against a general method. This fact is also probably the principal reason why such a method has in practice proven satisfactory, because the increasing percentage of the reservation may cover any shortage in the original calculation. It should be noted that the reserve recommended is to cover both depreciation and contingencies; it is at once a replacement fund and an insurance fund—a provision for something which must happen and something which may happen. From the accounting standpoint, separate reserves are preferable.

While this book will be especially valuable to the electric light employee, it has also a value for the public accountant of wide interest and practice.

H. C. MILLER.

Book Department

BOOKKEEPING FOR ACCOUNTANT STUDENTS. BY LAWRENCE R. DICKSEE, F.C.A. 7th ed. *London, Gee & Company.* 1913. 5sh.

Any treatise bearing the name of Dicksee is of interest even though it be merely a new edition of a standard work. In this case, inasmuch as there is no material alteration in the nature of the work, it is sufficient to note the evidence of solid merit in the treatise as shown by its being the seventh edition of a book first published twenty-one years ago.

Minor points may indeed be open to criticism. An instance may be found in the author's statement:

When an item is on the right-hand or Cr. side of the Ledger: (a) If the amount will eventually have to be paid, it is a liability. (b) If the amount will not eventually have to be paid, it is a gain. This rule never fails.

But an item indicating that cash has been paid out is on the right-hand side of the ledger, and obviously indicates neither a liability nor a gain. If the author, however, meant not an item but a balance he still needs to explain such a balance as that of "reserve for depreciation," which equally fails to live up to his so-termed unfailing rule. It is also to be regretted that in the glossary of foreign accounting terms, several typographical errors in the French and German terms have escaped the proofreader's and the author's eyes.

It is interesting to note that in the elaborate *pro forma* ledger given in the text, the closing "balance sheet" appears as a regular ledger account, although the author elsewhere states that such treatment is no longer favored, except on the continent.

HENRY RAND HATFIELD.

PRINCIPLES OF FACTORY COST KEEPING BY EDWARD P. MOXEY, JR., Ph.D., C.P.A., pp. 102. *The Ronald Press Company*, 1913.

This is a small book of less than one hundred pages, but it is well worth reading. It does not attempt to go beyond its title, which speaks well for the author. Every business man, every accountant and accountancy student should understand the established principles of cost keeping. Many of us could not install a creditable cost system in a factory without more technical knowledge than we now possess, but there is no excuse for inability to talk intelligently on the subject.

This book presents the subject of factory costs in such a readable and logical way that anyone with the slightest comprehension of the subject can follow the text readily, and thus acquire enough of a working knowledge of principles to discuss the purposes and advantages of cost accounts.

It also serves as a good introductory treatise to the elaborate and technical books on cost systems.

ROBERT H. MONTGOMERY.

THE STOCK EXCHANGE PAST AND PRESENT, By A. H. WOOLF, pp. 121. *Gee & Company*, London, two shillings and sixpence net.

A series of articles which appeared in *The Accountant*, of London,

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has been made the framework of a concise and interesting review of the development of the London stock exchange and of the growth of speculation and more permanent investment. The author, who is an English barrister, does not attempt to deal with the legal aspects of stock exchanges but merely reviews the history of their growth and influence. There are chapters dealing also in a very cursory way with continental bourses and with Wall Street. Mr. Woolf begins his story in the reign of William III and brings it down to date. The book may be recommended to students of finance as an excellent review of stock exchange practice in Great Britain.

ELECTRIC LIGHTING ACCOUNTS, BY GEORGE JOHNSON, F.S.S., F.C.I.S. (*The Accountants' Library* Vol. XXIX) pp. 171. *Gee & Company*, London. Seven shillings and sixpence net.

Messrs. GEE AND COMPANY have issued a second edition of Vol. XXIX in their *Accountants' Library*. This is a somewhat extended treatise on electric lighting accounts by GEORGE JOHNSON, F.S.S., F.C.I.S. The author reviews the laws affecting this class of accounting, gives detailed analyses of accounts, and provides a little of everything that the accountant concerned with this class of public utilities in Great Britain would be likely to require. The considerable differences between practice in Great Britain and America make it somewhat doubtful if this book will be of much value to practitioners in America but there are many points common to both countries and it is interesting to make a comparison of conditions.

THE ENGINEERING INDEX ANNUAL FOR 1913. *The Engineering Magazine Company*, New York, 1914.

The latest edition of this valuable work follows the general scheme of its predecessors but certain additions and changes are made which considerably improve the style and handiness of the book. It is a compilation of the engineering and technical literature of the year, much of which has already appeared in the monthly index published by *The Engineering Magazine*. The index is divided and subdivided under the principal subjects concerned, and each book or article indexed is briefly described as to title and general contents. The index is intended as a guide to the great mass of literature which appears each year and performs a function of the greatest service to everyone interested in engineering and other technical matters.

The present volume brings the record down to the December, 1913, monthly part of *The Engineering Index* covering the literature on engineering to October, 1913.

DE MORTUIS NIL, NISI BONA. BY SPICER & PEGLER. *H. Foulks Lynch & Company*, London, 1914. Five shillings net.

For many years it has been generally assumed, with a good show of reason, that accounting problems are almost unequalled in their dryness, but Messrs. Spicer and Pegler, of whose versatility we have now no

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further doubt, have conceived the excellent idea that it is possible to combine wit and wisdom even in matters of accounting. In the book before us there is a series of problems in executorship law and accounts presented in a most attractive way and embellished with some remarkably clever and humorous illustrations. The text of the problems is singularly devoid of technicalities and plentifully enlivened with matter in lighter vein.

This is the first volume of accounting problems known to humanity which can be read for the humor of it and yet it has a more serious and valuable side for those who care to investigate it.

THE INCOME TAX AS APPLIED TO PERSONS. BY JOHN NICHOLSON, of the New York Bar.

This is a pamphlet of 26 pages which purports to be a guide to enable the individual citizen and the foreigner resident here to determine with facility their rights and obligations under the federal income tax law, both in their relations to the government and in transactions with other persons. It is not to be expected that one can find at this time anything which will bring a fresh light to the elucidation of the numerous points of controversy and doubt in this complicated problem; and the most that can be looked for is a statement in form and language sufficiently simple to bring the principles of the law and the regulations for its administration within the scope of a layman with ordinary intelligence.

Probably the author of the pamphlet under review has achieved success along the line above indicated as well as any of those whose publications on the subject have appeared. He has divided the subject under captions which, with the index provided, enables the reader to get, without much difficulty, the law and regulations as applied to his case.

The pressing necessity of such a guide may have passed, but as the income tax is likely to be a permanent public burden in this country it is the duty of every one to become conversant with the law and study of this pamphlet should amply repay the reader for his trouble and give him a good working knowledge of the statute as affecting the individual.

GUIDE TO THE STUDY OF AUDITING. BY SAMUEL F. RACINE.

Published by *The Western Institute of Accountancy, Commerce & Finance*, Seattle, Wash., 1914. 63 pages. \$1.00.

This is a very full and valuable analysis of MONTGOMERY'S *Auditing Theory and Practice*, arranged in question form for the purpose of facilitating study. It is in a sense an amplified index and should prove of considerable service to students and others.

Correspondence

Treatment of Sinking Funds

Editor, *The Journal of Accountancy*:

Sir: I read with interest the article entitled *Treatment of Sinking Funds*, by Chas. S. Ludlam, which appeared in the March issue of *THE JOURNAL*.

On page 170 under paragraphs 8 and 9, the author states that the premium or discount on bonds purchased for the sinking fund is a profit or loss to the mortgagor. It would be extremely interesting to know whether the premium or discount should be carried in the sinking fund reserve or the surplus account. If the premiums or discounts are to be entered in the reserve account, it is apparent that a readjustment of the amount to be set aside for the retirement of the bonds at maturity would be necessary.

The author also states that current assets should be transferred to the sinking fund, without making a charge to income to accumulate a reserve. I fail to see the advantages of this method for the following reasons: First, the facts are not properly recorded unless a special reserve is created; second, the directors of the corporation may pay dividends if the amount is not set aside; third, there is no difference in the final result.

To illustrate the third point: A corporation issues bonds to the amount of \$5,000,000, and the accounts show the condition of the company before the issue to be as follows:

| <i>Assets</i> | |
|--|------------------|
| Plant and property | \$5,000,000 |
| Current assets (excess over current liabilities) | <u>500,000</u> |
| <i>Liabilities</i> | |
| Capital stock | \$ 4,500,000 |
| Surplus | <u>1,000,000</u> |

After the bonds are sold, the cash proceeds would appear temporarily among current assets until additions to the property were made. Assume that the mortgage requires that a sinking fund be established to retire the bonds in twenty years. On the theory that the instalment will be paid from current assets without making a deduction from income, the accounts as a result of the method employed will reflect the following condition at the end of twenty years:

| <i>Assets</i> | |
|--|---------------------|
| (a) Plant and property | \$10,000,000 |
| (b) Sinking fund | 5,000,000 |
| (c) Current assets (excess over current liab.) | <u>500,000</u> |
| Total | <u>\$15,500,000</u> |

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Liabilities

| | |
|-------------------|---------------------|
| (d) Capital stock | \$ 4,500,000 |
| (e) Bonds | 5,000,000 |
| (f) Surplus | 6,000,000 |
| Total | <u>\$15,500,000</u> |

Items (b) and (e) would be eliminated after the bonds are paid, and there would be \$5,000,000 more in the surplus account at the end of the period than at the beginning, represented on the asset side by additions to plant and property. If the charges had been made to income during the twenty years, we would have as a result a surplus of \$1,000,000 and a reserve of \$5,000,000; this latter amount could be transferred to surplus after the bonds are paid. In the meantime, the advantage is had of a proper record of the facts.

During the twenty-year period, the corporation is in effect making additions to plant and property from its surplus earnings. In order to pay dividends it must have additional surplus earnings sufficient to provide current assets from which to pay them. Is it sound finance for a corporation to borrow money in order to pay a sinking fund instalment, the current assets having been depleted because dividends were paid? It would not be necessary to create a second debt if the company had maintained a reserve or an adequate surplus. An indebtedness incurred to pay sinking fund instalments would still remain after the bonds had been paid.

GEORGE W. SHIPWAY,
Certified Public Accountant.

New York, May 4, 1914.

Treatment of Mortgages and Values

The Editor, The Journal of Accountancy:

Sir: Many accountants allow stockholders of a corporation, members of a partnership or individuals to fool themselves or their creditors by not installing a system that will give the full facts within the same space allowed in a report for partial and misleading facts.

One great fault is where a piece of real property is sold on contract and no attention is given to the liability to deliver under certain conditions. At the time the contract is made the honors are even and, after the first payment is made, the cash received is a new form of an asset but the liability remains the same. In short, the net liability on a contract sale is the original amount of the contract less the unpaid balance. The property has not been deeded and no profit can be considered until the title passes. The cost or book value of the real property is listed under assets, the payment on the principal of the contract sale is an asset,

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and the net amount due on the contract is a debit charge against the liability to deliver. It is the case of a conditional sale and "when property is sold on contract it belongs to the seller until title passes."

The interest on deferred payments is income but no profit on the sale of the real property can be taken until the title passes.

Some argue that the liability would only be the amount of the contract less the estimated profit to be realized, but I claim there is no absolute proof that the terms of the contract will be fulfilled and, therefore, no profit can be considered until the actual transfer of title has taken place. If the known profit at the time of making the contract is credited to "anticipated profits on uncompleted sale contracts," and "contract sale agreements at cost value" is credited with an amount equal to the value carried on the books for the asset sold on contract, the deal will be stated in full.

Another loophole which is very often taken advantage of is where real property is purchased on the basis of a certain value, "subject to" a mortgage for a certain known amount.

The attorney states that the debt is against the property and not a liability of the new owner of the property, therefore the innocent person or wildcat schemer hides either intentionally or not under the veil produced by the statement made by the attorney.

The real property was purchased on the basis of a certain known value and a known debt must be paid before the title to the property is clear, therefore the value of the property should be considered the asset and the amount of the mortgage a liability. The equity being considered and no liability mentioned is in error, misleading and the cause of much harm to innocent persons.

For an example of my views I give a copy of a "modified balance sheet" for a large investment company, and claimed by its board of directors to be based upon a report made by a well-known firm of accountants. This report had previously been published in full. The "modified balance sheet" referred to is set forth as follows:

Assets

| | |
|------------------------------------|----------------|
| Real estate | 000,000,000.00 |
| Agreements of sale | 000,000,000.00 |
| Mortgages | 00,000,000.00 |
| Bills receivable | 00,000,000.00 |
| Accounts receivable | 00,000,000.00 |
| Stocks of other corporations | 000,000.00 |
| Furniture and equipment | 00,000.00 |
| Cash | 000,000.00 |
| Total | 000,000,000.00 |

Liabilities

| | |
|-------------------------|----------------|
| Gold notes | 000,000,000.00 |
| Home certificates | 0,000,000.00 |
| Accounts payable | 00,000.00 |
| Trust funds | 00,000.00 |

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| | |
|--------------------------------|-----------------------|
| Dividends (uncalled for) | 00,000.00 |
| Capital stock | 000,000,000.00 |
| Surplus | 000,000,000.00 |
| Total | 000,000,000.00 |

It is a well-known fact that there is a large amount still unpaid on the real estate and the "agreements of sale" indicate that the title has not passed, and, therefore, I will now give an example of how I claim the balance sheet should read.

Assets

| | |
|---------------------------------------|-----------------------|
| Cash | 00,000,000.00 |
| Accounts receivable | 0,000,000.00 |
| Notes receivable | 0,000,000.00 |
| Mortgages receivable | 0,000,000.00 |
| Stocks of other corporations | 0,000,000.00 |
| Real estate (at purchase value) | 000,000,000.00 |
| Furniture and equipment | 00,000.00 |
| Total | 000,000,000.00 |

Liabilities and capital invested

| | |
|--------------------------------|----------------------|
| Accounts payable | 0,000,000.00 |
| Dividends uncalled for | 000,000.00 |
| Trust funds | 000,000.00 |
| Contract sale agreements | 0,000,000.00 |
| Original amount | 0,000,000.00 |
| Less unpaid balce. | 00,000.00 |
| Mortgages payable | 00,000.00 |
| Gold notes | 00,000,000.00 |
| Home certificates | 000,000.00 |
| Total liabilities | 00,000,000.00 |
| Capital stock | 0,000,000,000.00 |
| Surplus | 0,000,000,000.00 |
| Total | 00,000,000.00 |

Too little attention is given by bankers, the purchasers of stock of a corporation, the purchaser of an interest in a partnership, etc., to the liabilities, and all assets items are sure to be given by the person presenting the statement, therefore a change as suggested by me above would protect all parties and state real facts. The liabilities have to be met and they are the facts that are most important since the stated assets will show the source from which the money for the payment can be realized. Liabilities not stated have caused more harm than can ever be calculated.

If the statement is presented to a banker for the basis of a loan, it is very easy to arrange it so that it will give the cost or book value

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and at the same time allow space to show the appraised or estimated value, and then the facts are clear to all parties concerned.

If real property is purchased by contract and no title passes until certain payments have been made, it is proper to record the deal as follows:

Real estate, title subject to contracts,

To real estate purchase agreements.

With explanations.

The payments on the contract will reduce the liability and the asset remains the same until the title has been transferred; it can then be written off and charged to real estate.

Yours very truly,

R. L. McCRA.

San Bernardino, California.

New York State Society of Certified Public Accountants

At the annual meeting of the New York State Society of Certified Public Accountants on May 11th, 1914, the following were elected officers for the ensuing year and directors for the terms specified:

President, Hamilton S. Corwin; first vice-president, J. Lee Nicholson; second vice-president, W. Sanders Davies; secretary, James F. Farrell; treasurer, David E. Boyce.

Directors for one year, Henry R. M. Cook, Charles Hecht, Charles E. W. Hellerson, Duncan MacInnes, Richard P. Tinsley, and William F. Weiss. Directors for two years, Howard B. Cook, Herbert C. Freeman, Frederick H. Hurdman, Ferdinand W. Lafrentz, John R. Sparrow and Edward L. Suffern.

Certified Public Accountants of Massachusetts, Inc.

At the annual meeting of the Certified Public Accountants of Massachusetts, Inc., the following officers were elected: President, J. E. Masters; vice-president, William Franklin Hall; secretary, George Lyall; treasurer, Gerald Wyman.

Maine Board of Accountancy

The next examination in Maine for certified public accountants will be held at Portland on June 23, 24, 25. Applicants must be either residents of Maine for one year, or certified public accountants of another state or under a foreign government which extends similar privileges to certified public accountants of Maine.

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The Pennsylvania Institute of Certified Public Accountants

The Pennsylvania Institute of Certified Public Accountants held its annual banquet on May 21st, 1914, at the Manufacturers' Club, Philadelphia. Mr. Alba B. Johnson, president of the Baldwin Locomotive Works, delivered an interesting and instructive address on "The Unrest of the World." Mr. Joseph Moore, Jr., president of the Philadelphia Clearing House Association, spoke on the "National Reserve Bank Act," and gave many interesting details as to the work and future development of the system.

British Society of Incorporated Accountants

The council of the Society of Incorporated Accountants and Auditors of Great Britain has issued the twenty-ninth annual report. During 1913, 151 new members were added to the society's roll, which at the close of the year contained 2,623 names. The number of candidates for examination was 552, of whom 378 passed. The income of the society for 1913 was £6,823, and at the close of the year there was a surplus of £9,632, exclusive of £2,685 held for benevolent purposes.

Announcements

Clinton H. Scovell & Co. announce the removal of their offices to 110 State Street, Boston.

Mackay, Irons & Co., chartered accountants, announce that they have opened an office in Dauntsey House, 4B Frederick's Place, Old Jewry, London, E. C.

Williams & West announce that their offices are now at 47 Canada Life Bldg., Calgary, Canada.

Henry M. Wechsler, C. P. A. and J. Emory Mills announce the formation of a partnership for the practice of accounting under the firm name of Wechsler & Mills, with offices at 46 Cedar St., New York.

Announcements

London dispatches to the daily papers here state that Arthur Whale, senior partner in the firm of Whale, Barnett & Co., chartered accountants, London, has a picture on the line at this year's Royal Academy exhibition. This is the second time that Mr. Whale has been successful.

Albert T. Bacon, certified public accountant, announces his removal to new offices at 901 Continental & Commercial Bank Building, 208 South La Salle Street, Chicago

It is announced, under date of May 14th, 1914, that Robert L. Cuthbert, C. P. A., has withdrawn by mutual consent and agreement as a partner from the firm of Arthur Young & Company, accountants and auditors.

David Rollo

We regret to announce the death of David Rollo, one of the original fellows at large of the American Association of Public Accountants and a certified public accountant of New York. Mr. Rollo was the eighth president of the American Association of Public Accountants and held office from 1898-1899. For some years he had been treasurer of John F. Betz & Son, Limited, of Philadelphia. His death, which occurred at 2314 Walnut Street, Philadelphia, followed an illness of several months' duration.

